

**KELLOGG:** *Kellogg's Corn Flakes*, fortified with vitamin D by 1941, increased to 100% MDR, 1956 (Tr. 29,716-17; CX-K 457); *Pep*, fortified with vitamins D and B1 by 1941 (Tr. 29,715-17); *Special K*, fortified [147]with seven vitamins and protein, 1956 (Tr. 29,716, 29,948; CX-GM 564C); *Concentrate*, vitamin fortified and protein enriched, 1958 (Tr. 29,716); *40% Bran Flakes*, fortified with 100% iron, 1966 (CX-K 487); *Product 19*, fortified with 100% MDR of eight vitamins and iron, 1967 (Tr. 29,663); *Sugar Smacks*, fortified with  $\frac{1}{3}$  MDR of vitamins and iron, 1967 (CX-K 7135S, 7352B, C); *Mini-Wheats* fortified with  $\frac{1}{3}$  MDR of vitamins and iron, 1969 (Tr. 11,786-87; CX-K 533); *Raisin Bran*, fortified with 100% iron by 1969 (CX-K 415, 7177F).

**GENERAL MILLS:** *Hi-Pro*, fortified with seven vitamins and iron, 1958 (GMX 180); *Total*, fortified with 100% MDR of eight vitamins, 1961 (GMX 179B); *Corn Total*, fortified with 100% MDR of eight vitamins, 1966 (GMX 180B); *Vital 7*, vitamin fortified, 1967 (Tr. 17,162); *Alive*, fortified with extra Vitamin B2, Niacin and Iron, 1968 (Tr. 16,979; GMX 181B); *Kaboom*, fortified with 100% MDR of eight vitamins and iron, 1969 (CX-K 765E; GMX 174B); *Buc Wheats*, fortified with  $\frac{1}{3}$  MDR of eight vitamins, as test marketed August 1970 (CX-K 765E; GMX 179B).

**GENERAL FOODS:** *Bran Flakes*, fortified with iron, 1966 (CX-K 487); *Fortified Oat Flakes*, fortified with six vitamins and minerals, 1967 (Tr. 37,052, 37,059; CX-GF 1406C); *Sugar Crisp*, fortified with  $\frac{1}{3}$  MDR of vitamins and minerals, 1967 (Tr. 37,052); *Alpha Bits*, vitamin fortified to  $\frac{1}{3}$  MDR, 1969 (CX-GF 601H); *Honeycomb*, vitamin fortified to  $\frac{1}{3}$  MDR, 1969 (CX-GF 601H).

**QUAKER:** *Quisp* and *Quake*, fortified with  $\frac{1}{3}$  MDR of vitamins and iron, 1968 (Tr. 15,044-45); *King Vitaman*, fortified with 100% MDR of vitamins and iron, 1970 (CX-K 765C).

501. In 1970, vitamin fortified brands accounted for some 17% of industry pound sales, and cereals fortified with iron accounted for another 6% of the market (CX 434). Respondents' fortification efforts prior to 1970 achieved competitive results—for example, the competitive impact of Kellogg's Product 19 on General Mills' Total (CX-K 7176A; CX-GM 567A), the fortification rivalry between Kellogg's Product 19 and Special K and General Foods' Fortified Oat Flakes (CX-GF 34A), and between General Foods' Sugar Crisp and Kellogg's Sugar Smacks (CX-K 595A, 7352B, C, I).

502. This fortification activity prior to 1970 took place not only in the climate of the pronouncements of the Council on Foods and Nutrition of the American Medical Association and the Food and

Nutrition Board of the National Research Council, related above (Finding 493), but also in the face of an adverse position taken by the Food and Drug Administration (FDA).

503. FDA policy adverse to the fortification of RTE cereal products was a major obstacle to RTE cereal fortification. During [148]the mid-1960's, the FDA publicly opposed fortifying RTE cereals beyond allowable limits, on the ground that the availability of vitamins to consumers from other sources made cereal fortification unnecessary (Tr. 29,949-50, 37,054-59).

504. In 1962, the FDA commenced rulemaking proceedings concerning regulation of processed food fortification (27 Fed. Reg. 5815 (June 20, 1962)). In 1966, it proposed a rule, Part 80.2 of which would have prohibited the addition to RTE cereals of vitamins and minerals other than niacin, thiamin, riboflavin and iron. Minimum and maximum limits covering the use of these four nutrients would also have been established (31 Fed. Reg. 8525-26 (June 18, 1966)) (KX 101; Tr. 29,718, 37,056). Part 80.2 embodied the prevailing FDA policy that restoration of vitamins to whole-grain levels constituted the maximum appropriate vitamin supplementation (Tr. 37,056). FDA held protracted hearings regarding the proposed regulation (Tr. 29,718; CX-CI 80A).

505. If adopted, the FDA regulation would have precluded the high levels of fortification subsequently adopted by respondents in 1971-1972, and would have required the reformulation of certain established fortified cereals (KX 101; *see, e.g.*, GMX 174 through 181; CX-GF 102K).

506. At the time of the FDA's rule proposal, respondents anticipated serious impact on their fortified cereals (Tr. 29,949). For example, in 1966, General Mills believed that the regulation threatened the future of its fortified Total: "[T]he probability of passage creates a serious potential threat to the brand" (CX-GM 564C). General Mills' 1969-1970 Total marketing plan stated: "Possible future FDA regulations could force elimination or massive reformulation of Total" (CX-GM 567A). Kellogg delayed increasing the iron content of Raisin Bran from 80% to 100% MDR until after it was advised that such action would not cause a government reprimand (CX-K 439B).

507. The effect of the FDA policy was to delay fortification of many cereals until the 1970's (Tr. 13,141, 29,717-19, 35,812, 37,053-55).

508. In addition to the FDA, American Medical Association and National Research Council opposition to fortification of foods and perhaps as a result of such opposition, there was limited consumer

demand for fortified RTE cereals during the 1960's and only limited, temporary success for products that were fortified (CX-GF 102G; CX-K 487; Tr. 15,043-44, 16,980-82). The record fails to indicate that respondents' individual competitive efforts prior to 1970 in the field of product fortification were not fully commensurate with the public demand. There is no evidence that indicates that respondents reached agreements concerning, or coordinated, their pre-1970 fortification conduct.

509. Throughout the pre-1970 period and thereafter, respondents individually engaged in extensive research to overcome technical [149]problems involved in cereal fortification. There have been many such problems including workable methods of fortification application, uniformity of product, unacceptable taste, odors and appearance, deleterious chemical reactions, maintenance of vitamin potency through the cereal processing procedure, maintenance of proper product moisture levels and shortened shelf life. These problems varied product by product and by the particular nutrient and combination of nutrients involved (Tr. 12,367, 13,004, 13,339-401, 13,670-71, 13,668-69, 14,150, 16,982, 29,280-82, 29,951, 32,911, 32,916-17, 35,808, 36,670-71, 37,002, 37,052-53, 37,062-63; GMX 373).

510. Some of the problems have been very difficult to overcome. For example, General Mills has never been able to add vitamins A and D to Cocoa Puffs or to add minerals other than iron to any cereals because of bad taste problem (Tr. 35,803, 35,813). Considerable expenses were incurred in researching and implementing product fortification (Tr. 16,982, 29,952-53; CX-GF 477).

511. General Foods' research into beneficial product additives was not limited to vitamin and mineral fortification. Starting about the end of 1959, General Foods promoted research on the possible inclusion of phosphates to inhibit dental caries. Much of this was done in conjunction with the Indiana University Foundation, as well as outside specialists and statisticians. Because of what appeared to be questionable research procedures, Indiana University and General Foods agreed to terminate the joint research arrangement in 1972. General Foods continues to perform animal research with phosphates (Tr. 37,110-11).

512. General Foods' unilateral investment of substantial sums in research into the prevention of tooth decay is inconsistent with complaint counsel's allegation that General Foods, in conjunction with other respondents, avoided having one respondent acquire a competitive advantage over the others. Respondents' overall, vigorous competition in the introduction of new products (*infra*, Findings

530-602) is also totally inconsistent with the charge that they conspired in the particular area of fortification.

513. In the late 1960's and early 1970's, there was a dramatic change in the national attitude toward the fortification of cereals. During 1969, the President had convened a White House Conference on Nutrition, which issued a report in December 1969 (GMX 501). That report was to the effect that there were significant nutritional deficiencies in the diets of large segments of the population. It was recommended that the proposed FDA regulations barring the fortification of breakfast cereals not be adopted, because the widespread acceptance and consumption of breakfast cereals made them effective carriers of essential nutrients. It attacked the view that all needed nutrients were obtained from ordinary diets and recommended strong food fortification programs (Tr. 35,811-12; GMX 501Z94-96, Z120-22, Z-253). Consequently, the FDA abandoned its proposed rule to prohibit food fortification (Tr. 29,718, 37,057-58). [150]

514. The Conference increased consumer interest in vitamin fortification and provided impetus to the fortification programs of each respondent, which resulted in whole-line fortification in the early 1970's (Tr. 13,140, 29,719-20, 35,057-08, 35,810-11).

515. At the time of the White House Conference, congressional hearings were being held, but there was no resolution of the matter at that time (Tr. 37,058).

516. Subsequently, in July 1970, Mr. Robert B. Choate, a civil engineer, in testimony before a congressional committee, criticized the lack of nutrients in RTE cereals. Mr. Choate's testimony further increased industry and consumer interest in vitamin fortification. His testimony was widely publicized, and the majority of RTE cereal consumers were aware of it (Tr. 37,061-62; CX-GF 3000Z-105).

517. Choate rated RTE cereals by name as to their nutritional value. As a result, certain fortified brands benefited from Choate's highly publicized testimony (Tr. 29,951-52). Sales of four fortified cereals, Fortified Oak Flakes, Total, Special K and Product 19, improved after Choate testified (CX-GF 477C, 1429B; KX 4; CX-GF 340A). Purchase of certain nonfortified cereal brands, Wheaties, Cheerios, Rice Krispies, and Grape Nuts, appeared to decline (CX-GF 1429B; see CX-GM 16A, 17A).

518. Kellogg had commenced development of the systems necessary for extending fortification at the one-third MDR level to all of its cereals in the late 1960's, at which time Kellogg had decided to fortify all products (Tr. 29,278-81). Kellogg, at the time of Choate's testimony, had already begun to install the equipment required to

apply increased levels of eight vitamins called for in its expanded fortification effort. This enabled it to begin production of cereals fortified at the new, higher vitamin levels within several months of Choate's testimony (Tr. 29,952-53; see CX-K 7187R). Kellogg's decision to fortify its entire line was given additional impetus by the 1969 White House Conference on nutrition (Tr. 29,719-20). The decision had already been made to fully fortify prior to Choate's testimony (Tr. 29,719-20).

519. Kellogg's Sugar Pops, Froot Loops, Apple Jacks, Sugar Frosted Flakes, Cocoa Krispies and Puffa Puffa Rice were fortified by late 1970 or early 1971 (CX-K 7187R). Two of Kellogg's largest selling brands, Corn Flakes and Rice Krispies, were not fortified until 1972; Corn Flakes was not fortified until September of that year (CX-K 7192F, 7193G, 7209E).

520. General Mills decided to fortify all its cereals to the  $\frac{1}{3}$  MDR level of seven vitamins and iron on September 17, 1970 (Tr. 35,814; GMX 373). It fortified the majority of its cereals from August 1971 to January 1971 (GMX 174 thru 182). Fortification of Cheerios and Wheaties was in August 1971, and General Mills' established presweetened cereals were fortified from October 28, 1971, to January 1972 (GMX 174, 175, 177, 179). [151]

521. General Foods' decision to fortify its entire line of cereals preceded Choate's testimony (Tr. 37,052, 37,062). By February 1970, General Foods was prepared to fortify its entire line of cereals (at  $\frac{1}{3}$  MDR vitamin and 100% MDR iron) subject to "Business Manager approval" (CX-GF 2022E). Choate served to accelerate implementation of General Foods' decision (Tr. 37,062). By late 1970 or early 1971, General Foods had completed its plan for such fortification and set a schedule to fortify its brands through 1971 and 1972 (CX-GF 477). General Foods planned to fortify its cereals in stages—first the presweets by September 1971, and then the remaining cereals by March 1972 (CX-GF 477C). The project was actually completed in 1971 (Tr. 37,059).

522. General Foods, through advertising and other promotional activity, attempted to secure a competitive advantage for its fortified products (CX-GF 340B, 477C). Kellogg recognized that it had been disadvantaged by General Foods having fortified its Raisin Bran before Kellogg did so (CX-K 7198D, E).

523. Kellogg introduced its newly fortified line of cereals in 1971 with an aggressive advertising and promotional campaign (CX-K 765R, S, U, W, Y, Z-2). However, since Kellogg had lagged behind its competition by not fortifying its most popular brand, Corn Flakes,

until September 1972, it lost sales to General Mills' Cheerios and Wheaties and to General Foods' Post Toasties (CX-K 7192F, 7209E).

524. The foregoing recitation of respondents' activities in the area of product fortification reveals that they were fully consistent with individual, competitive responses to stated public policy and consumer interest and demand.

Complaint counsel, however, assert (CPF 8-227 thru 8-233; CRPF 8-264 thru 8-269) that respondents convened meetings of the Executive Committee of the Cereal Institute on July 27, 1970, and August 21, 1970, in order to agree on how to respond to the attacks of Choate and others on the cereal industry for its failure to provide nutritious food, and that respondents there reached agreement on how to fortify their RTE cereals. This agreement is evidenced, according to complaint counsel, by the contemporaneous actions of respondents to fortify to the  $\frac{1}{3}$  MDR level.

525. The July 27, 1970, meeting of the Executive Committee of the Cereal Institute was called "to consider the impact of the recent testimony of Robert Choate in which he attacked the nutritional value of cereals" and to decide upon "what action if any should be taken by the Institute on behalf of the industry to introduce proof of the nutritional value of cereals before the Subcommittee and otherwise to repair the damage done by the unjustified statements and charges of Mr. Choate" (CX-CI 78B). The only action taken at the meeting, that was evidenced, was that of authorizing the Institute to arrange for a [152]leading nutritionist to testify before the Senate subcommittee "as to the nutritional value of breakfast cereals and their place in the American diet" (CX-CI 78B).

526. On August 21, a special meeting of the Board of Directors of the Cereal Institute was held to discuss the testimony by Institute and industry witnesses which had been presented to the Senate subcommittee on August 4, and to discuss further efforts to educate the public on the role RTE cereals played in a nutritional diet (CX-CI 80). It was noted in the minutes of the meeting that Senator Moss of the Senate Subcommittee had suggested that the cereal industry should eliminate differences in the nutritional content of breakfast cereals and make greater progress in educating the public of nutritional facts concerning breakfast cereals; and that Mr. Paxton, the Cereal Institute's legal counsel, had advised that "despite the senator's suggestion, the elimination of product differences might not be an appropriate matter for concerted action" (CX-CI 80A).

527. The record contains no evidence that respondents discussed any plans for action regarding fortification at either of the two Cereal Institute meetings. Representatives of Kellogg and General

Mills who were present at the meetings testified that there were no agreements regarding fortification (Tr. 29,720-21, 35,463, 35,806, 35,815). And the record contains no evidence to overcome this testimony. Nor is there any evidence that the respondents otherwise communicated regarding their fortification activity, or that any respondent had advance knowledge of the fortification plans of the others. General Mills became aware of competitors' fortified products only when they appeared on retail shelves (Tr. 35,814).

528. Not all cereals were fortified to the  $\frac{1}{3}$  MDR level (Tr. 29,663, 37,095; CX-K 765C). To the extent they were, this is not surprising inasmuch as breakfast is one of the three usual daily meals, and respondents were being responsive to recommendations of the White House Conference regarding fortification levels (GMX 501Z-101, Z-121, Z-197-98, Z-231, Z-232). General Mills was unaware of Kellogg's and General Foods' plans when it set fortification levels (Tr. 35,808, 35,814).

529. Complaint counsel do not challenge the right of respondents to belong to the Cereal Institute. The two meetings of the Institute, relied upon by complaint counsel for their hypothesis of agreement, have not been shown to have been conducted for other than legitimate purposes.<sup>48</sup> There is no basis for an inference that [153] fortification activities, which were most reasonable in the light of ongoing events, were in response to an otherwise unproved agreement rather than the ongoing events.

#### 4. *Introduction of New Products*

Complaint counsel assert that there is a barrier to entry into the RTE cereal industry and would place responsibility for the existence of the barrier upon respondents. The cornerstone of the barrier to entry theory, which theory will be considered in the next section, has been termed by complaint counsel "brand proliferation." It is complaint counsel's position that respondent's avoidance of competition by other means led them to turn to brand proliferation, "the introduction of a large number of differentiated, highly advertised trademarked brands" (CPF 1-31, 9-1, 9-3, 9-35; CRPF 9-2, 9-10, 9-11).

530. Complaint counsel and their expert witnesses have conceded that respondent's brand proliferation is vigorously competitive, not predatory and not in itself unlawful (Tr. 22,607, 22,614-15, 22,622,

<sup>48</sup> The Cereal Institute was founded in 1941 for the purpose of advancing public understanding of the nutrition offered by cereal products (Tr. 11,863-72).

22,629, 22,865, 22,906, 23,264, 23,304, 23,678, 27,267; GFX 1166A-B, 1167).

531. Respondents engaged in unrestrained and uncoordinated competition in the introduction of new products. Such competition was intense (Tr. 21,922, 22,056, 22,605-08, 22,905-06, 22,615), and there is no evidence of a conspiracy or intent to deter entry by means of new product introductions (Tr. 22,109, 26,693, 27,028, 28,284, 30,518-23, 30,538).

532. Respondents, therefore, may not be held responsible for the results of this legitimate method of competition unless it was the proximate result of their having otherwise limited their competitive efforts as charged. However, as I have already held, complaint counsel have failed to prove those charges. Further, even if respondents had conspired or otherwise unlawfully coordinated their other competitive efforts, new product introduction would still have remained as a legitimate vehicle of competition. There is no causal relationship shown between the alleged avoidance of other kinds of competition and competition by brand introduction. Not only is there no showing of proximate cause, but, if respondents had conspired to fix prices or had engaged in price leadership-price followership in lieu of overt collusion, competition by introduction of a large number of differentiated products would have been avoided as the antithesis of such coordinated behavior (*see, supra*, findings 192-97).

As found above (Findings 229-31, 238-39, 245-47, 250-51, 323-26), respondents did not want to engage in price wars and the record does not evidence strong price competition among them. This is consistent with Professor Schumpeter's theory that firms in oligopolistically-[153]structured industries would tend to pursue competitive strategies which could not easily be matched by their rivals; that price competition, for example, would give way, among other things, to the development of new products, whereby a company could secure an extended competitive advantage (Tr. 38,276). As Dr. Scherer has written, *Industrial Market Structure and Economic Performance* 342 (1st ed. 1970):

[A]ny fool can match a price cut but an ingenious promotion campaign is hard to counteract.

This may well explain the emphasis by respondents on competition through new product introduction rather than price competition. But respondents may not be held accountable for any results flowing from their individual choice to pursue this lawful means of competition.

The following findings, therefore, are not necessary to my disposi-

tion of the issue of the introduction of new products, but are included for the use of a reviewing authority in the event it might take a different view.

533. Consumers desire variety for breakfast (Tr. 14,421, 14,446, 17,191, 17,398-401, 22,751, 35,367, 35,400, 35,447, 36,372; CX-CI 103Z-64; GFX 1153Z-71). Such a desire is responsible in large measure for the differentiation of RTE cereals (Tr. 22,751). A firm in the RTE cereal industry must introduce new products in order to remain profitable and compete for market share (Tr. 38,520, 38,797-98, 38,830; CX-CI 103Z-5).

534. Kellogg's policy has been to rely primarily on its proven brands, but to build on top of them with new products having good potential (CX-K 397D, 549C, 7358F). It believes that if it has a product with wide appeal, it must introduce it or someone else will; that it is better for Kellogg to continue to expand its products even if it is taking some business away from other Kellogg products than for a competitor to do so (Tr. 13,046-51, 29,954, 29,683-84).

535. "Although Kellogg does not agree that all profitable opportunities in the ready-to-eat cereal market have been exploited, Kellogg is doing its best to continue to exploit those additional opportunities . . ." (KPF 5-155).

536. General Mills stressed new product introduction at increasing levels as a major competitive effort and sought to outdo competitors in this regard (Tr. 17,353-66; CX-GM 38A, 608F, 609M, 610W). It believed it to be imperative to continue to introduce competitive new products (CX-GM 263A). General Mills was concerned at the inroads on its own absolute sales volume and market share that new products of its competitors might make (CX-GM 3D, E). Both General Foods and Kellogg recognized General Mills' policy of stressing new product introduction (CX-GF 4039Z-1; CX-K 553H).  
[155]

537. General Foods also recognized a competitive requirement to introduce new products. As early as the 1950-1952 three-year plan for the Post Cereal Divisions, we find (CX-GF 167Z-10):

The need for new products which could augment our volume, help carry our overhead, and at least potentially contribute to profits has long been recognized. Since the total cereal business is at best stationary, and since therefore our principal chance to increase our volume is to take business away from competitors, new products are vitally important. It is not easy to increase the share of business done by our older established products.

538. General Foods, from the early 1960's, introduced new products in an attempt to maintain total volume and to make up for declining sales of established General Foods brands. New products

were also viewed as the key to growth (Tr. 14,140, 36,371; CX-GF 4A, 17D, 324A, 602K, 2044D, 4039Z-53).

539. General Foods, in 1967, decided to remain in the RTE cereal industry by placing a high priority on developing new products (CX-GF 4039D, G). In its proposed marketing plan for FY's 1968-1970, we find (CX-GF 4039Z-59):

The underlying assumption for Post new product strategy is that over the next three to five years continued competitive new product pressures, compiled with a static market will force volume losses on brands currently being marketed. . . .

\* \* \* \* \*

Therefore, Post's new product program will be designed over the next three years to provide new products to hold or slightly grow total Post volume.

540. Changes in American society in the 1950's and 1960's, with resultant changes in consumer demand, contributed in large measure to the introduction of new RTE cereal products. The "baby boom" significantly affected the RTE cereal industry. Since RTE cereals are so convenient, the increase in the number of children offered a great opportunity for producers to develop new products to appear to them (Tr. 29,621-22, 29,786-87; CX-GM 736A). Because of the increased pace of modern living and the increased number of women in the labor force, there was an even greater demand for RTE cereals [156]which children could eat without parental assistance (Tr. 29,623-24, 29,787). Other shifts in demand, including the call for nutritious and natural cereals, also impelled respondents to introduce new products (Tr. 26,256, 29,680-84, 29,787).

541. The advent of television enabled respondents to visually impact consumers with the claimed benefits and attributes of new products. This ability to have a direct, nationwide impact on potential consumers facilitated the sale of new products and provided an incentive to respondents to develop new products (Tr. 27,100-01, 29,624, 29,702-07, 29,780-81; CX-GM 736A; CX-GF 4U; CX-K 563D).

542. New products were introduced by each respondent in order to compete against other RTE cereal manufacturers. Kellogg, for example, introduced a new product, Puffa Puffa Rice, so that it would not be preempted by a Quaker product, Tin Tin, that was being successfully marketed in Canada (Tr. 12,380-83, 12,891-92, 12,965-66, 22,131, 23,081-82, 30,706-07; CX-K 7163A). Kellogg introduced Product 19 to compete with General Mills' Total (Tr. 12,396-98, 12,839-40; CX-K 7353H), OK's to compete with General Mills' Cheerios, Froot Loops to compete with General Mills' Trix, and

Cocoa Krispies to compete with General Mills' Cocoa Puffs (Tr. 11,907-12, 12,684-94, 12,875-76, 13,545-46, 29,661-62; CX-K 502C). And Kellogg introduced its granola in response to entry into that segment by competitors (Tr. 13,087-88), as did General Mills (Tr. 17,802).

543. General Foods, during the early to mid 1960's, spent several million dollars to introduce a line of corn flakes with fruit (GFX 416D). It considered this to be a very exciting opportunity to secure a real competitive advantage, to the point of overtaking Kellogg (Tr. 36,380-81; GFX 1297). Even with respect to new products that were essentially variations of existing ones, General Foods sought to capture a small but profitable share of the total RTE cereal business (CX-GF 6T).

544. While respondents' new product introductions, to some extent, expanded the RTE cereal market by appealing to additional consumers and inducing consumers to eat more cereal products (CPF 9-286; Tr. 7573, 11,432, 13,010, 15,223-26, 17,681-82, 29,678-79, 29,780, 35,410, 35,417, 35,421-22; CX-K 560C; CX-GF 4039Z-53), they did have a competitive impact on respondents' other RTE cereal products, either by a reduction of sales or by adversely affecting sales growth (Tr. 7551, 7559-70, 8824-25, 14,198-99, 14,088-89, 14,220-27, 14,966, 15,222, 15,754-55; GMX 71, 73, 97, CX-K 397C; CX-GF 1455I).

545. Kellogg did not believe that every new product had to be profitable as long as the whole line showed a profit (CX-K 565I, L). Kellogg introduced new products when necessary to stop competitors from making inroads into Kellogg's business (Tr. 11,316; CX-K 686B). Kellogg believed that the introduction of two products at the same time reduced product trial (Tr. 12,965-70; CX-K 604A-C). Kellogg increased its advertising on Froot Loops while General Mills was [157]seeking to introduce Lucky Charms (Tr. 22,133-34). It also increased its advertising of Special K when General Foods introduced Fortified Oat Flakes (CX-GF 34).

546. General Mills introduced products with relatively low life potential in order to boost its overall line share of the market and counter a potential loss of customers to competitors' new products (CX-GM 3D, E). It introduced new brands as defensive moves to help prevent competitors' new brands from taking hold (CX-GM 2A, C, 262B, 276, 2171C, 2176F). It sought to keep its own products on the shelves, even though it recognized they had no future, until it could introduce still more of its own products to replace them (CX-GM 285). General Mills increased its advertising, use of coupons, and use

of samples with Total during Kellogg's introduction of Product 19 (Tr. 17,620-29, 23,075; CX-GM 21, 123A, B, 570N, Z-15, 720A).

547. General Foods introduces a new product only when it is believed to meet a perceived consumer demand and a reasonable profit can be anticipated (Tr. 36,372). It has never introduced a product that it did not think would succeed (Tr. 13,666, 36,435), although it did not expect its brand introductions in the 1960's to be as long lived as older brands (CX-GF 4039Z-59). It has introduced line extensions of particular cereals (e.g., flavor variations) to induce consumers to stay with its products rather than try RTE cereals of competitors (Tr. 17,481-82; CX-GF 1455C, 2029B).

548. Kellogg believed that the growth of sales in an area meant that there might be an opportunity for a new brand in that area. Its general practice, therefore, was to identify areas of opportunity for new brands by looking at the sales growth of particular brands in particular market areas (Tr. 12,832-41).<sup>49</sup>

549. Kellogg has many sources for its new product ideas. These include brainstorming sessions involving Kellogg employees and members of its advertising agency (Tr. 29,977); outside consulting firms (Tr. 30,034); and observations of the marketplace (Tr. 16,534-35, 16,871-73, 29,795, 37,014-15, 37,030; GFX 1299). For example, Kellogg continually monitors the products of its competitors to determine whether an opportunity for an improved product exists (Tr. 12,269, 12,404, 29,801-02). Kellogg's General Sales Manager urged all Kellogg product marketing managers to watch for the product innovations of small manufacturers. He advised marketing managers to [158]"keep especially alert for successful locally marketed products that could be duplicated and mass-produced for national marketing—especially those compatible with our existing product lines" (CX-K 676B). Once such an idea was obtained, Kellogg, because of its technological capabilities, could improve on it and make the Kellogg product available nationwide (Tr. 12,184, 29,609-11).

550. Almost every department at Kellogg has some responsibility for the development of a new product, including the research and development group, the marketing research group, the process development, packaging development and quality control groups, the administrative group, the controllers and the purchasing people (Tr. 29,774, 37,032-33). The product development coordinator, whose position was established in 1958, is responsible for facilitating a

<sup>49</sup> For example, the growth of General Mills' Total led Kellogg to develop Product 19 (Tr. 29,795-96); Froot Loops were introduced to take advantage of an opportunity to appeal to users of the first fruit-flavored presweet, Trix, another General Mills product (Tr. 12,875-76).

product's orderly progression through its developmental stages into test market and general distribution (Tr. 29,773-75).

551. Kellogg made extensive use of marketing research tests to determine consumer reaction to various characteristics of products. This included blind paired comparison tests to determine what consumers deemed to be significant differences between products (Tr. 11,638-39, 12,957-62, 29,846). This was to prevent the offering of a me-too product (a product without a significant difference), which is recognized to be a likely failure in the marketplace (Tr. 9184-88, 12,965, 14,516-25, 14,584-86, 14,966-67, 15,228, 15,847, 15,851-53, 15,952, 17,453, 17,627-31, 17,634, 17,650, 22,722, 26,549; CX-K 396B).

552. Thus, the development of a new Kellogg product calls for expensive testing, including consumer panel tests, concept testing, blind paired comparison tests, in-home tests, central location tests, test marketing, as well as taste testings which expert respondent employees are continuously engaged in (Tr. 15,981-16,046, 29,800, 29,843-46, 32,970-82, 37,039-44).

553. Although each new product may vary as to the steps in development and problems encountered, Product 19 affords some perspective of what can be involved in the development of a new product (Tr. 29,794). Kellogg observed the success of General Mills' Total, as well as vitamin and mineral supplements like One-A-Day vitamin pills and Geritol. Kellogg analyzed and tested Total and decided that that product indicated an area of opportunity for Kellogg (Tr. 29,795-96).

554. Kellogg employees from all sections of the company then gathered to discuss the characteristics, technological needs, and competitive potential of the desired product. Upon establishment of a product objective, research personnel were put to work. They requisitioned the use of a pilot plant and laboratories for the manufacture of a product prototype. Once work on the product had begun, the group met constantly to review the prototype and its progressive transformations (Tr. 29,796-99). [159]

555. After the manufacture of what was believed to be a successful prototype, Kellogg employees conducted internal taste tests in which they compared the Kellogg product with Total. Generally, after a prototype has elicited positive responses from an internal taste panel, Kellogg turns it over to members of the process development department, the packaging department and the research department for further improvements. Meanwhile, Kellogg continues testing the product in order to insure consumer acceptance. If the results of these tests are encouraging, the company hires professional testing organizations to conduct panel tests among

consumers. Because the results of the new product's consumer tests were positive, Kellogg decided to go ahead with it, Product 19 (Tr. 29,800, 29,835-37, 29,846-48, 29,887-88).

556. Once Kellogg decided to market Product 19, its production required technology that had never been used under manufacturing conditions. In order to test this technology, Kellogg established a manufacturing pilot plant with actual-sized equipment, but on a smaller scale. This plant cost \$550,000.00. Product 19 was test marketed in 1966 throughout the Pacific West Coast, in Florida and in Texas. Although the product lost money during test marketing, Kellogg had expected the loss and considered it an investment (Tr. 29,848-52, 37,246-47; CX-K 7368B).

557. After being test marketed for 18 months, Product 19 proved to be a success. Kellogg then established a full-scale production facility which cost approximately \$4 million. This investment did not return any profits until Product 19's third year of production. It took seven years to recoup the product's early operating losses (Tr. 29,854-55, 29,858).

558. New product ideas at General Mills are generated from several sources, such as research and development, marketing research and interviews with consumers. New product ideas are first concept tested with consumers. A concept test is based on a pictorial representation and a written or oral description of the proposed new product. New product ideas which are well received by consumers are then guidance tested with consumers. Guidance testing is a sequence of tests in which groups of 50 to 75 consumers taste the product and respond to written questions concerning its attributes. The product is modified after testing in response to consumer input. A product that is rejected by consumers is not pursued. Products that survive guidance testing are then put through large scale evaluative testing. Here, the product is placed with a representative sample of 300 to 600 consumers to determine its level of satisfaction (Tr. 15,966-71, 15,978-79, 15,983-97, 15,999).

559. General Foods periodically analyzed the RTE cereal market by looking at segments of people and brands to try to find an unoccupied space or gap in the market. Brands were arrayed in relation to each other based on how people perceived them, and how they were rated with respect to particular attributes. People indicated what brand they would substitute if they could not find a [160] certain product. New product ideas were suggested by the study reports (Tr. 14,192-93, 14,407-16).

560. General Foods' market research department regularly conducted product testing, advertising research, information-gathering

on marketplace performance, test marketing research, attitude studies, packaging tests and other types of research (Tr. 14,344; *see, e.g.*, GFX 584).

561. The market research department also collected information about the types of people who were buying different products—"consumer profiles." Studies to learn what was happening in particular markets were also conducted (Tr. 14,345-46).

562. General Foods' and competitors' new products and their performance were evaluated (Tr. 14,346; GFX 552). Market Research conducted product quality tests in which consumers were asked to compare General Foods brands with other cereal products (Tr. 14,472-74; GFX 547, 549).

563. Information was secured from syndicated types of services, such as A.C. Nielsen Company, SAMI and MRCA and from market research organizations (*see, e.g.*, Tr. 14,349; GFX 289, 537, 547; CX-GF 1348).

564. General Foods' market research department thus was able to obtain information concerning the incidence of cereal purchases, the demography of the consumer groupings and the frequency of purchases (Tr. 14,365).

565. An effort was then made to come up with products that answered people's wants so identified and measured (Tr. 14,370).

566. Market research would track a new product's performance in terms of volume, share of market and consumer feedback. Such tracking would aid in the development of new product ideas (Tr. 14,368).

567. Consumer testing continued long after the introduction of a brand. General Foods tried to determine how its products were performing in the marketplace and to evaluate new opportunities (*see, e.g.*, GFX 535, 552).

568. New product ideas came from many sources—personal experience, marketing sources, marketplace sources, but primarily from technical sources (Tr. 37,015). Some ideas were generated in brainstorming sessions (*see, e.g.*, GFX 1299).

569. Following a brainstorming session, representatives from technical research, marketing research and marketing would meet to select those ideas which appeared to have merit (Tr. 37,032). [161]

570. These ideas would then be presented to potential consumers in an "omnibus test," for group discussion and evaluation. This is also known as "concept testing" (Tr. 14,417, 37,035, 37,037).

571. After omnibus testing, highly regarded product concepts would be considered for feasibility by technical personnel who would

develop prototype products reflecting particular ideas (Tr. 37,037, 37,223).

572. A prototype would be exposed to the consumer through market research. Research and development personnel would consider feedback and modify the product accordingly (Tr. 13,412).

573. Further consumer testing would be conducted, exposing prototype products to hundreds or even thousands of families for their reactions (Tr. 37,040).

574. If the product still looked promising, it would be test marketed to indicate what might be expected on a national scale (Tr. 36,440, 37,043).

575. If the product performed well in test market—if it appeared that its potential volume was sufficient to constitute a viable business—it would be introduced nationally. Not all products that were test marketed went into national distribution (Tr. 37,043–44).

576. Performance of a product in national distribution usually lagged behind performance in the test market. If a product failed to meet the goals set for it, it was withdrawn (Tr. 37,044–45).

577. Each product concept was evaluated several times as it was developed to determine whether it justified additional investment. Many concepts would be discarded; others would move forward toward the marketplace (Tr. 36,375–76).

578. General Foods had a New Product Committee, composed of senior managers in the RTE cereal business, to evaluate ideas and to decide whether they justified further investment (Tr. 36,375).

579. Utilization of excess capacity was one of the considerations in evaluating new product development opportunities (Tr. 13,481; GFX 423C).

580. Several of General Foods' new products were offshoots of products made by the Jersey Cereal Company, the small RTE cereal producer that General Foods had acquired (CX-GF 167Z-11).

581. In 1950, 26 brands were in distribution beyond test market. During the next 23 years, the largest six firms introduced 84 brands beyond test market, of which respondents accounted for 60, and withdrew 30 of the 84 introduced. Thus, the number of RTE cereal brands in the market increased from 26 in 1950 to 79 in 1973 [162] (Tr. 22,024, 22,029–31; CX 405). Broken down into five year periods, we find the following:

Initial Decision

99 F.T.C.

	<u>Brands Introduced Beyond Test Market</u>
1950-55	8
1956-60	15
1961-65	22
1966-70	19
1971-73	20

(CX 407)

582. Because of the influx of new brands, established brands lost market share. The top eight brands accounted for 47.3% of the market in 1964, a drop from 56.9% in 1954 (CX-PG 6B, C). Corn flakes, which accounted for 33% of total RTE cereal sales in 1940, had only a 10.8% share in 1972 (CX-K 7054A, 7148C, 7209D). From 1950 through April 1970, average market share per RTE cereal brand declined from about 4% to about 1.3%, and the average pounds sold per RTE cereal brand declined from around 22 to 18 million pounds. This was despite a substantial growth in total sales (Tr. 22,030-31; CX 409A).

583. RTE cereal pound sales increased by 78% between 1955 and 1972. Products introduced prior to 1955 accounted for only slightly more than 10% of this increase, while products introduced after 1954 accounted for almost 90%. By 1971, about 36.9% of RTE cereal sales consisted of products introduced in the prior 16 years (GMX 564). Respondents' products that existed beyond test market distribution prior to 1955 increased in aggregate pound sales by 107,125,000 from 1955 through 1970 (GMX 564E-F, I).

584. The parties differed in the degree of product introduction activity during the period. Whereas Kellogg was introducing products throughout the 1950's, General Mills increased its introductions in the mid-1950's, and both General Foods and Quaker increased their introductions in the late 1950's or early 1960's. After General Foods introduced Krinkles and Corn-Fetti in 1950 and 1951, it introduced only one more new RTE cereal product before 1959 (GFX 1370H).

585. Between 1950 and April 1972, Kellogg introduced 24 brands into test market or beyond (CX-K 1067); General Mills introduced 34 (CX-GM 2049, 2111); and General Foods introduced 21 (CX-GF 556, 18690).

586. Following General Foods' decision to emphasize its new product activities in FY 1962 (CX-GF 4039Z-17), it introduced nine [163]new RTE cereal products in the next five years (GFX 1370H-I). Quaker did not introduce a new RTE cereal product until 1961.

Kellogg introduced products at a fairly constant level throughout the complaint period, with slightly more activity in 1959 (CX 409B, E).

587. The respondents' success with new products differed. During the complaint period, Kellogg introduced nationally 16 new RTE cereal products. All but three found widespread consumer acceptance and were still on the market at the close of that period (Tr. 29,600-01; CX-K 1067, 7173; CX 434). The other respondents and Quaker all had varied success, with General Foods being the least successful (Tr. 27,009, 27,434, 38,331-32; CX-GF 4039Z-4). General Foods marketed fewer brands of RTE cereal in 1973 (15) than it did in 1964 (17) (GFX 1370).

588. The firms have also had differing success with respect to their already established products. Kellogg's older products have had a good deal of durability. Their sales increased by about 25% since 1958. Sales of General Mills' older products were flat; General Foods' sales of older products declined; and Quaker's sales of older products declined to a little more than half of their 1958 levels (Tr. 38,335-36; GMX 565).

589. Based on market share, the cereal industry became a business of relatively small brands (CX-GF 17A, D, 601Z-5, 602B; CX-K 7342C; CX-GM 2178D). An analysis of the peak market shares achieved by RTE cereal brands introduced from 1950 through 1972 shows that only seven of the 84 introductions had market shares exceeding 2% (CX 434):

BRANDS	YEAR OF INTRO.	PEAK SHARE AND YEAR
Kellogg's Sugar Frosted Flakes	1953	6.3% 1971
Kellogg's Special K	1956	4.1% 1970 & 1971
GF's Alpha Bits	1957	2.7% 1959
GM's Total	1961	2.6% 1967
Quaker's Cap'n Crunch	1965	2.4% 1965
Quaker's Life	1961	2.0% 1966 through 69
GM's Jets	1954	2.1% 1955

Of those seven, only Sugar Frosted Flakes, launched in 1953, achieved a 5% market share or better; only one achieved 4% or better; and the remaining five achieved between 2% and 3% at their peaks. No brand introduced after 1956 and before 1972 achieved 3% or more of the market. Respondents generally considered a new brand a success if it could sustain a market share in the 1% to 1.5% range (Tr. 11,723-26, 15,964, 17,746; CX 434J; CX-GM 2A, 179E, 276A, 591F, 603B, 700B, 2198B; CX-GF 20A-C, 30A, B, 470H, I, K, 1372F, H, 1389E, 2018A, C; CX-K 742A, 995). [164]

590. However, as indicated above, not all new product attempts

were successful. For example, from 1968 through 1971, six new products were introduced in the presweet segment of the RTE cereal market. Of these, at least five were definite failures (CX-GF 4010I, Z-39, Z-40).

591. As Quaker analyzed the 1958-1969 period (CX-Q 177H):

Since 1958, 76 brands of RTE cereal have been introduced into either test market or national distribution. Of these, only 54% are still on the market. Of the 36 RTE cereal brands on the market before 1958, 34 are still on the market.

The failure rate for new brands is even higher than indicated by these data since a considerable number of brands still on the market do not have a large enough share to qualify them as real successes. By dividing the study period into halves it appears that the number of introductions and the proportion of failures increased in the more recent years.

592. From 10 failures of 25 introductions in the 1958-1963 period, the failure rate increased to 35 of 51 introductions in the 1964-1969 period (CX-Q 177M). Altogether, 50% of the RTE cereal brands introduced beyond test market between 1950 and 1972 failed (Tr. 26,406, 26,416-17, 26,758-59; CX-GF 4010I, Z-39, Z-40; CX-Q 177H, M; CX-K 547B; CX 435).

593. Of 26 brands introduced prior to 1950 that were in the market in 1950, 23 were still available at the end of 1972. Of nine brands introduced in the five year period 1950-1955, eight were still available at the end of 1972. Comparable figures for subsequent five year periods are: 1956-1960, 10 of 21 still available; 1961-1965, 12 of 37 still available; 1966-1970, 15 of 42 still available (CX 435). These figures which show the number of brands that were withdrawn after introduction, do not reflect the numerous and costly efforts which did not culminate in products worth introducing, e.g., the cavity preventive RTE cereal effort of General Foods (*supra*, Finding 511).

594. General Foods, in particular, experienced difficulty during the 1960's in its introduction of new brands of cereal and was repeatedly unsuccessful (GFX 1370). It had costly failures in its attempts to develop and introduce cereals with freeze-dried fruits (Tr. 37,046-47).

595. The fixed costs necessary to launch a new individual brand include those of research and development of the brand, market research, production equipment and plant and introductory advertising (Tr. 21,964-65, 21,969-70). [165]

596. The fixed costs are significant. The major RTE cereal producers spend on average about \$180,000 to research and develop

and test consumer acceptance of each brand they launch (Tr. 21,969, 26,408; CX-CI 103Z-47; GFX 1153Z-47; CX-NC 500 at p. 34).<sup>50</sup> The major RTE cereal producers also spend substantial amounts for new plant and production equipment for many of their new brands (Tr. 21,970). Kellogg spent some \$4 million to \$6 million for new equipment for Product 19 (Tr. 13,203). General Mills planned expenditures of \$1.1 million and \$1.8 million, respectively, on new equipment for a new health and a new puff cereal (CX-GM 607E). The Danville plant of Quaker, used initially for King Vitamin, cost more than \$6 million.

597. The most significant fixed cost of launching a new RTE cereal is introductory advertising (Tr. 21,969-70).<sup>51</sup> Newly introduced brands require disproportionately heavy advertising to achieve market penetration (Tr. 12,809; see CX 508A).

598. Substantial introductory advertising expenditures are necessary in order to persuade enough consumers to try new brands (Tr. 12,466-69, 14,435-39, 15,038, 15,771, 15,777-80, 17,301-03; CX-GF 4010Z-42, 4039Z-56; CX-GM 2180C). Unless it intensively advertises a new brand, an RTE cereal producer cannot get many retailers to place the new brand on their shelves. Retailers will not place a new RTE cereal brand on their shelves unless the manufacturer provides or promises to provide sufficient introductory advertising to "pre-sell" the new brand to consumers (Tr. 8919, 9185, 9348-50, 12,722-24). The high advertising level of the many RTE cereal brands already in the market (the high "noise level") requires high introductory advertising expenditures for new RTE cereals (Tr. 13,097, 14,437-38, 15,038, 15,243-44; CX-GM 557H). Kellogg's Marketing Director has stated:

It is not unusual for a new product introduction to involve an *initial* outlay for advertising and promotion money that far exceeds the total dollar volume of sales for the first year's introduction. Unless the product succeeds in an *unusual* way—it may become virtually impossible to *ever* recover [166]the cost of introducing the new product (CX-K 552G) (emphasis in original).

599. By late 1961 or early 1962, General Foods concluded that introductory advertising expenditures of around \$3.5 million were necessary to launch a new brand expected to achieve a 1% market share (CX-GF 17A, D). General Mills stated that the heavy introductory advertising it planned for Smiles (\$4.1 million) was essential for success (CX-GM 603E, H, W). The respondents and Quaker spend

<sup>50</sup> General Foods spent between \$150,000 and \$300,000 on research and development for Alpha Bits during its first three years (Tr. 13,436, 13,635-37).

<sup>51</sup> Advertising during the first 12 months a product is placed in national distribution is considered introductory advertising.

substantial sums on introductory advertising for each brand they introduce. Between 1956 and 1972, they spent on average some \$3.2 million per new brand (Tr. 26,399-404; CX 206, 508; CX-Q 177Z-20).

600. Not only are the fixed costs of developing and introducing a new product very high, but there is an extended leadtime in going from the drawing board to national distribution and in reaching a break-even point. Dr. Schmalensee, complaint counsel's economic expert, agreed that it takes approximately four years to get a new product off the drawing board and into national distribution and another three years to achieve a break-even point on the product (Tr. 23,413-14).

601. General Mills' development time for Mr. Wonderful's Surprise and Golden Grahams, products that required new technology, was in excess of 10 years (Tr. 32,990). For products developed primarily on existing technology, General Mills' development time averaged from five to six years (Tr. 17,237, 32,989). General Mills began experimental work on Buc Wheats in 1964, but did not introduce the product Buc Wheats until 1971 (Tr. 32,914, 32,989).

602. The foregoing demonstrates that respondents engaged very heavily in new product competition; that this method of competition was expensive and risky and that there was a long period of time before even a successful new product venture would pay off. It has also been demonstrated that, as a result of respondents' new product competition, individual cereal brands on average accounted for smaller shares of the market and lower poundage of sales.

#### V. IMPEDIMENTS TO NEW ENTRY INTO THE RTE CEREAL INDUSTRY

##### A. *Brand Proliferation*

##### 1. *Complaint Counsel's Theory*

Complaint counsel (CPF 9-1 thru 9-338; CRPF 9-1 thru 9-112) would place responsibility upon respondents for the lack of new entry into [167]the RTE cereal industry. The following is a summary of complaint counsel's theory of the existence of a barrier to entry and respondents' responsibility therefor.

The RTE cereal industry has enjoyed supracompetitive profits (an issue which will be dealt with later in this initial decision) and was growing rapidly. This should have attracted new entry into the industry. The absence of such entry indicates the existence of a barrier to entry. Respondents' brand proliferation conduct raised effective barriers to the entry of new RTE cereal producers and provides the complete answer to this absence of entry. While brand

proliferation is not in itself unlawful, respondents must be held responsible for its deterrent effects upon entry, since respondents turned to this method of competition as a result of their mutual avoidance of other means of competition.

As I have already found (*supra*, Findings 529-31), brand proliferation in this case is nothing more than the introduction of new brands as a legitimate means of competition and did not result from any other activities of respondents. Thus, respondents cannot be held legally responsible for the impact upon potential new entrants of their introduction of new products. However, for purposes of providing complete findings, I shall continue with complaint counsel's theory of respondents' brand proliferation as the sole barrier to entry into the RTE cereal industry.

The proliferation is said to be of highly-differentiated, intensively advertised, trademarked, new RTE cereal brands. The brands actually differed to varying degrees or, by reason of advertising, the consuming public was led to believe they differed. In this manner, competition among RTE cereal brands was "localized"—the first of three basic conditions under which brand proliferation will cause a barrier to entry.

When competition is not localized, a change in price, advertising or promotion of one brand would equally affect all other brands, and industry-wide reaction could be anticipated. The introduction of a new brand would similarly affect all other brands in the industry. A potential entrant would look to the market as a whole for its source of sales and would anticipate being able to take comparable percentages of sales from all existing brands. Any reaction to the new entry by existing competitors would impact all brands in the market.

On the other hand, when competition is localized, a change in price, advertising or promotion of one brand would affect primarily the other products in the segment in which it is located, and reaction would be anticipated only from the other brands in the segment. The introduction of a new brand would affect significantly only the brands in the segment into which the new brand had been introduced. The potential entrant could look only to the segment [168] into which it was considering entry for its source of sales. Existing competitors would react only in the segment involved without impacting other brands in the industry. In sum, the new entrant would have a more limited area from which it might secure sales and it would anticipate more direct competitive reaction from the existing brands in the segment it had entered.

The second basic condition, under which complaint counsel assert

that respondents' brand proliferation has created a barrier to entry, is termed "brand immobility." This means that the attributes of existing brands are so firmly established in the minds of consumers that the brands cannot be repositioned to appeal to those who want different attributes. Consequently, when a new brand is entered into a segment, existing brands cannot avoid competition by changing their appeal but must meet the competition of the new brand head on. A potential entrant, therefore, would anticipate this head-on competition from existing brands in the segment considered for entry and so might be deterred from entry.

The third basic condition of complaint counsel's assertion that respondents' brand proliferation has created a barrier to entry is the existence of substantial fixed costs associated with the development and introduction of a new product. These are production, marketing and distribution costs which do not vary directly in proportion with the amount of the item produced.

Respondents are said to have so crowded the market with their products that the introduction of additional, profitable brands by new entrants has been foreclosed.

As the demand for cereals grew, opportunities for new brands did occur. Except for the granola or natural segment of the market, these opportunities or "holes" in the market were filled by the six existing major producers. This is because the existing majors were already operating at an overall efficient scale, so that it was profitable to add an additional product even though the volume of that product alone would not cost justify an outsider entering the RTE cereal industry. An outsider would need several simultaneous successful product entries of the size that can be anticipated in this industry before it could operate at minimum efficient scale and so not be at a cost disadvantage to respondents.

This would be most unlikely since it is difficult to develop successful brands; and by the time an outsider could be ready with several brands, an existing firm could fill any particular hole or opportunity that might exist.

In sum, complaint counsel assert that there is a product efficiency of scale equal to about 1% of the market, whereas firm efficiency of scale is not reached until sales of 3.5% to 5% of the market are achieved. Respondents, all of whom are already operating [169]at or above firm efficiency of scale, can introduce a new product whenever a 1% opportunity appears, whereas an outsider cannot. The outsider is faced with the insurmountable task of finding simultaneously three or more opportunities in order to enter the market at

minimum firm economy of scale so as not to be at a cost disadvantage to respondents.

Complaint counsel assert that an outsider would have to find larger individual holes or opportunities than respondents since respondents do not react to each other in a competitive fashion, whereas they would react very strongly to an outsider's entrance in a particular, limited segment.

The requirement to achieve entry by multiple brands is also said to have deterred entry since the entrant would have to expend large capital costs on each of the several brands to be introduced. Complaint counsel assert (CP 9-29):

The conclusion that respondents' brand proliferation practices have increased a potential entrant's capital costs is based on the previous analysis demonstrating that a potential entrant can no longer expect to attain entry at efficient operating scale with a single brand. The necessity of a multi-brand strategy means that the entrant must fund several research and development efforts, several introductory advertising programs, and possibly several production lines. The record shows that it is much more expensive to develop and introduce five brands whose total sales will fall in the range of from 3.5% to 5% of the market, than it is to develop and introduce a single brand to achieve the same market share. The additional costs of entry via a multi-brand strategy are so great that many smaller firms simply cannot raise the necessary capital. The magnitude of the required capital does not prevent entry by the largest firms, but it does result in their acting more cautiously. If the cost of entry were significantly lower, the attractiveness of the industry would result in more frequent gambles by many firms. But as the costs grow, fewer gambles are taken and firms are likely to exercise such great caution that by the time they have decided to enter, their original brand ideas may have been preempted by one or more brand introductions by respondents. [170]

## 2. Localization<sup>52</sup>

603. Localization or segmentation of brands is the first of the three necessary conditions under which, according to complaint counsel, brand proliferation will cause a barrier to entry. As I have previously found (Findings 59-150), there are segments or categories of cereals within which brands compete more strongly with each other than with other brands because of their similar attributes, and there are some cereals that are so similar that they compete with each other on a one-to-one basis. The record, however, does not permit an exact delineation of the segments and the degrees to

<sup>52</sup> Consumers' desires for variety in breakfast are responsible in large measure for the differentiation of RTE cereals (*supra*, Finding 532). Respondents, for example, may be said to have reacted to children's desires for presweetened and flavored cereals, to many consumers' desires for natural cereals and to many other consumers' desires for fortified cereals. Respondents, therefore, may not be held responsible for localization of this nature. Localization, to the extent it has come about by what complaint counsel term "brand proliferation" is the result of competition by means of introducing new products to appeal to the varying desires of different categories of consumers.

which competition among cereals is confined to those cereals in particular segments. The necessary corollary to this description of localization, as shown to exist in the RTE cereal industry, is that some cereals have a broader appeal than the particular segment or category in which they fall so that they compete to varying degrees with cereals outside of their category.

604. For example, adult products, such as Total, Special K, Product 19, All Bran, 100% Bran and 40% Bran Flakes, not only compete with each other, but also compete strongly with all-family products, such as Cheerios, Rice Krispies, and Corn Flakes. And children's products, which are essentially the presweets, not only compete with each other but compete strongly with the all-family products (Tr. 35,367-70; GMX 194, 195, 546A, 547A-B, 548A-B, 549A). While some presweets compete more directly against other presweets, all 30 or so presweets compete to some degree with each other (CPF 9-172; CX-GF 4K, 1410A, 1439, 3000Z-95; Tr. 22,778-81). Grape Nuts competes with all RTE cereals for its share (CX-GF 40), while Post Raisin Bran competes strongly with General Foods' presweetened cereals (GFX 1210Z-5).

605. Twenty-one other brands each accounted for over 1% of the RTE cereal consumption of the two-member families that purchased [171]Cheerios in 1969-1970. For 1975-1976, 25 other brands each accounted for more than 1% of their consumption (GMX 518A-B). Two-member families consuming Kellogg's Corn Flakes had more than 1% of their consumption accounted for by each of 20 other brands in 1969-1970 and by each of 23 other brands in 1975-1976 (GMX 520A-B).

606. Many consumers of RTE cereals are interested in many product attributes such as puffing, flaking, specific grains, shapes, textures, flavors and degrees of sweetness. The number of directly competing brands is determined by the number of attributes relevant to each consumer's purchasing decisions. The number of direct brand competitors increases as the number of attributes relevant to particular consumers increases (CPF 9-185, 9-186, 9-188; Tr. 21,953-54, 22,078-80, 22,771-78, 26,253-54).

607. It is uncontested that RTE cereal products compete on the basis of varying numbers of in-common characteristics that differ in importance, but that no analysis was made to quantify the numbers of direct competitors as a result of these in-common characteristics (Tr. 22,753-54, 22,777, 22,794, 23,892-93).

Inasmuch as localization is a necessary predicate to complaint counsel's barrier to entry by proliferation theory, the question arises whether localization exists to the degree required. As an abstract

theory, it is logical to assume that a new product's success would be limited by the size of the area or segment within which it is to compete. However, to the extent that it may draw customers from outside of its primary segment, its success potential becomes less limited.

608. While the extent to which localization prevails in the RTE cereal industry is an unknown, it exists to a sufficient degree to have the type of impact theorized by complaint counsel.<sup>53</sup> Respondents believed that the effect of increasing the number of brands on the market was to increase segmentation (CX-GF 17A, D), fractionalization (CX-K 7342C; CX-GM 2178D), or fragmentation (CX-GM 601Z-5). "The cereal industry has become a business of small brands." Kellogg believed that "a lot of products on the market in 1970 will account for *less than one percent*," as a result of the continued introduction of new brands. This would result in fewer brands with large market shares (*i.e.*, 3-5%) (emphasis in original) (CX-K 565J). [172]

### 3. Brand Immobility

609. Brand immobility is the second of the three conditions under which complaint counsel contend that respondents' brand proliferation has caused a barrier to entry. While I would not expect that a manufacturer of an existing product would, even if it could, reposition a product to accommodate a new entrant,<sup>54</sup> the condition of brand immobility has been established on the record.

610. It is difficult to reposition a product from an idea or concept that people have gained. It may be hard to get people to accept the product's new position if they have associated the product over time in its former position. There is a good deal of risk and expense involved in trying to change people's established concept of a product (Tr. 14,212-13, 14,466-68). General Mills has learned that when you try to make radical changes, you sometimes lose the entire market. It doesn't make sense to reposition an RTE cereal product after it has gone national (Tr. 15,762-63, 17,707-11; CX-GM 2476F-H).

611. Attempts at repositioning have failed. Kix was originally an all-family cereal. It had always had some consumption by children. As Kix's sales declined, General Mills attempted to move the brand more toward children. General Mills changed the package, used

<sup>53</sup> Since localization is an element in evaluating crowding, the comments at the end of my findings on crowding (*infra*, Finding 621) apply equally here.

<sup>54</sup> With the large number of products in the market catering to all nature of consumer wants, there would be no point to the manufacturer of a successful existing product to pick up and run from a new entrant and attempt to compete in a different area. There is no evidence that an existing brand has ever been repositioned to accommodate a new brand.

Kix's first in-pack premium and urged retailers to place Kix in a presweet shelf position. These efforts at repositioning were not successful. The result was a lowering of Kix sales. Former adult consumers ceased buying it, while it failed to win children's support (Tr. 17,316-18, 17,323, 17,662-65; CX-GM 124B, 2173). General Mills attempted to reposition Trix by changing its shape, texture, sweetness, package, and name. The attempt destroyed the identity of the product and Trix sales decreased significantly (Tr. 17,708-11; CX-GM 2476F-H). An attempt by Kellogg to reposition Cocoa Krispies towards younger consumers was unsuccessful (Tr. 12,887-88).

612. When introduced, Clackers' advertising and its premium offer positioned it as a child cereal. Because of its low repeat sales, General Mills considered repositioning the product. However, [173] General Mills believed it would be very difficult to persuade adults to purchase the product since the original image had been established so strongly. Instead, the product was withdrawn from the market (Tr. 16,039-41, 15,758-60; CX-GM 2049A).

#### 4. *Fixed Costs In Development And Introduction Of A New Product*

613. The third prerequisite, under complaint counsel's premise that respondents' brand proliferation has created a barrier to entry into the RTE cereal industry, is the existence of substantial fixed costs associated with the development and introduction of a new product. This requirement has been met. As I have previously found (Findings 595-99), there are significant fixed costs necessary to launch a new product including the costs of research and development, market research, production equipment and plant and introductory advertising.

#### 5. *Crowding of the Market*

614. A market would be crowded when existing firms have packed it so densely with their brands that another brand cannot enter and generate enough sales to earn a normal return. Sales opportunities available to an entrant must be sufficient to cover the costs of introducing new brands and yield at least a normal rate of return. Fixed costs establish a certain minimum volume required to break even. Crowding deters entry because an entrant is prevented from attaining the break-even point in sales output (Tr. 21,987-88).

Complaint counsel assert (CPF 9-221) that respondents' brand proliferation activities have crowded the market so as to reduce the

opportunity for the introduction of new brands; that "[i]n some areas [or segments] of the market crowding has proceeded to the extent that the remaining sales opportunities, or holes, are so small that no one, including established firms and potential entrants, could launch a brand and expect to achieve sales sufficient to become profitable."

615. As found above (Findings 530-31, 534-89), each respondent has made a planned and concerted effort to find and seize upon every opportunity for the introduction of a profitable new product; and Kellogg and General Mills have found it to be to their respective competitive advantages to introduce new products even when they may not be individually profitable. New product introduction has outdistanced market growth, as demonstrated by the reduced market share and poundage sales of the average RTE cereal product. [174]

616. In the face of high fixed costs, opportunities for profitable new brand introductions declined as the number of brands on the market increased (Tr. 12,424-25; CX-K 552G, 565I-L, 604A, B; CX-GM 2178D, E, G; CX-GF 1455C). The increased number of cereals on the market correspondingly increased the possibility of new brand failures (Tr. 11,465, 11,672-74). Kellogg believed that the sodium free corn flake segment which consisted of another seller's brand, was too small to support a profitable entry by Kellogg (Tr. 12,840), and that "the market is over saturated with cocoa-flavored products" (CX-K 7205D).

617. General Mills concluded that the market is so "highly fractionated [that] opportunities to successfully introduce unique new cereal products . . . are limited" (CX-GM 2178D); and that "[t]he successful introduction of new cereal products has become increasingly difficult in a market which has reached maturity" (CX-GM 2178G). General Mills conducted a market research test which showed that the bran segment of the RTE cereal market would not support another bran product, Alive/Bran Wisps. General Mills decided not to introduce that product into the national market (Tr. 15,798-804; CX-GM 2049).

618. General Foods observed that "[t]he presweet segment is crowded with over 30 brands competing for 21 share points, for an average SOM [share of market] of less than 0.7%" (CX-GF 2021C). In 1972, it found that "subsegments of the presweet category are becoming saturated" (CX-GF 4010Z-10). For example, the unflavored, presweetened rice area would not support a new General Foods cereal, an unflavored Pebbles (Tr. 17,456-58).

619. Quaker concluded that a major inhibiting growth of the presweet cereal market was consumer "satiety" with uniquely

flavored products. So many differently flavored cereals were on the market that opportunities for new brands were limited (CX-Q 2631B). It also believed it was unlikely that an opportunity remained in the spoon-sized shredded wheat segment for an additional brand capable of reaching the 1.24% market share that Quaker estimated was necessary for profitability (CX-Q 183A-B).

620. Complaint counsel's theory that the introduction of all of the products that can profitably compete in an area will dissuade the entry of still more products is a logical one, and the situation clearly has obtained in the RTE cereal industry. This, however, is just another way of saying that competition will deter entry and the more vigorous the competition, the more likely it is that new entry will be deterred. Here, complaint counsel have merely evidenced and analyzed how competition by existing firms in the form of new products will deter entry by new firms.

621. While crowding has undoubtedly deterred new entry into some areas, the areas so precluded, their economic significance, and the [175]time periods of preclusion have not been identified (CPF 9-221, 9-270, CRPF 9-3, 9-38, 9-49, 9-52). This limitation of proof weakens complaint counsel's position that respondents' brand proliferation constitutes the sole reason why there has been a failure of new entry into the RTE cereal industry.

## 6. *Preemption*

Faced with the fact that established firms have introduced numerous brands during the period covered by the complaint, complaint counsel agree that crowding is not the complete explanation of why new firms did not enter. It is necessary to go one further step. That step is preemption (CPF 9-289 thru 9-291). As explained by complaint counsel (CPF 9-291):

It is obvious that in a changing market entry deterrence does not result solely from the crowding effect of brand introductions. Crowding cannot be the complete explanation of entry deterrence because crowding will affect existing firms as well as new firms. However, existing RTE cereal firms and potential entrants differ in ways that account for the ability of existing firms to launch new brands while new firms cannot. One difference is that respondents' brand proliferation strategies have resulted in a more crowded market with reduced average brand market shares, thus making it more difficult for new firms to achieve efficient firm size, in the range of 3.5% to 5% of the market, without entering with several successful brands. Potential entrants, therefore, are more likely to adopt an entry strategy based on multiple brands. Respondents, having already achieved efficient firm size, do not need to locate multiple brand opportunities. They can launch single brands as the opportunities develop. A second difference is that new entrants must have different expectations as to the reactions their brand introductions would provoke from the established firms.

That difference would lead prospective entrants to be more uncertain and more cautious, causing their brand development ideas to be preempted by respondents' brand introductions (Schmalensee, Tr. 22,647). These differences lead to preemption, *i.e.*, they operated to deter potential entrants while respondents are able to introduce new products (Schmalensee, Tr. 22,113-18). [176]

(a) Preemption By Reason Of Economies Of Scale

622. Complaint counsel assert (CPF 9-292) that economies of scale are not reached at the firm level until the firm acquires from 3.5% to 5% of the RTE cereal market. A potential entrant would not wish to enter at less than minimum efficient size because it would then have higher costs and lower profits than the respondents and would be at a considerable competitive disadvantage (Tr. 22,115, 26,409-11). (This finding is subject to the comments contained in the paragraph following Finding 624.)

623. However, the opportunities for developing a product that can achieve sales of 3.5% to 5% of the market are practically nonexistent; and respondents, who are already operating at or above minimum efficient scale, are constantly searching for opportunities to introduce products at the 1%-1.5% level, a profitable level for them (*supra*, Finding 589). Thus, existing firms are in a position to preempt the entry of potential entrants by introducing individual products into perceptible market holes before potential entrants can develop and introduce the multiple products necessary to reach the 3.5% to 5% minimum efficient firm size. Even if a potential entrant were to consider attempting to develop a product that might achieve 3.5% to 5% of the market, respondents, by repeatedly introducing smaller volume brands, would remove the possibility that an opportunity for a 3.5% to 5% brand might come about (Tr. 22,116-19, 22,930-31, 26,409-10). (This finding is subject to the comments contained in the paragraph following Finding 624.)

624. In summary, respondents can seize every individual new product opening as it appears, whereas an outsider would have to wait for an unusually large size or for a number of smaller normal size openings; and the respondents, by seizing each individual opportunity as it appears, preempt outsiders from ever having the opportunities they require to enter. (This finding is subject to the comments contained in the following paragraph.)

Thus, potential entrants would be disadvantaged in their efforts to introduce a new product into the RTE cereal industry. The extent of that disadvantage, however, depends upon the minimum efficient firm scale facing a potential entrant. Findings 622, 623 and 624, therefore, are conditioned upon the establishment of a 3.5%-5%

share of market as the minimum efficient firm size for a viable competitor in the RTE cereal market.

625. Economies of scale are those efficiencies related to volume of output that enable larger firms to produce and distribute their goods at lower average costs than smaller firms. As firm size [177] increases, average costs per unit of production decline until a firm reaches an output level called "minimum efficient scale." Unit costs beyond that level generally stay constant. Minimum efficient scale is that level of output at which all relevant economies of scale are achieved and at which unit costs attain their minimum value. A firm with this level of output would have costs as low as any firm in the industry. A firm with an output level below minimum efficient scale would find itself operating at a cost disadvantage relative to firms with higher levels of output. If a company were to enter an industry with a level of output below minimum efficient scale, it would have costs greater than existing firms in the industry and, therefore, might not be able to earn a competitive rate of return (Tr. 21,846-47, 22,991, 26,319; CX-CI 103Z-38, Z-39).

626. Complaint counsel assert (CPF 7-126) that "A study entitled 'The Structure, Conduct and Performance of the Breakfast Cereal Industry 1954-1964,' written by Robert S. Headen and James W. McKie in 1966 ('Headen-McKie Study', CX-CI 103), . . . provides a reliable basis for determining firm economies of scale in the RTE cereal industry." The Headen-McKie Study was commissioned by the members of the RTE cereal industry through the Cereal Institute, as an industry response to an anticipated report of the National Commission on Food Marketing, and was ultimately submitted to that Commission (CX-CI 59, 60, 62, 63, 64, 75, 170R-S, 172A-B, 173E-F, 177B-C). The study examined the behavior, the character and nature of competition, and the performance of the breakfast cereal industry as it existed during the period 1954-1964 (CX-CI 103C).

627. The study, among other things, considered production scale economies as a condition of entry. In consideration of the rate of technological progress in the industry, no empirical estimates of average costs at different output rates were derived, nor were any statistical cost studies made. The only information secured was by interviewing cereal production managers (CX-CI 103Z-38-39). The study reports (CX-CI 103Z-40):

The estimates obtained in discussion revealed that:

1. It would be "economically feasible" for a new entrant to enter the market with production facilities built to supply about 1% of the national market or approximately

12 million pounds of cereal. By "economically feasible" it is presumed that production managers felt that a plant built to this scale would not be as efficient as a larger one, but that the cost disadvantage would not be so great that the potential entrant could not earn satisfactory profits. [178]

2. It was felt that a fully efficient cereal plant could be built to a scale such that it would supply about 5% of the national market or about 60 million pounds per year. It is presumed then that the production cost disadvantage of a plant of this size would be negligible.

And at CX-CI 103Z-45, it is stated:

It was estimated in the above section on possible production scale economies that an efficient cereal plant would supply between 1% and 5% of the market.

628. Apart from production costs, the study considered media availability and costs, ability to get retailers to carry a new product, cost differentials in having a company sales force as opposed to using brokers, patent barriers, raw material availability and advantages of vertical integration; and found that these did not constitute significant barriers to entry (CX-CI 103Z-29-Z-38, Z-40-Z-45).<sup>55</sup>

629. The Headen-McKie conclusions on firm economies of scale have no analytical or other substantive support. As conclusions drawn from conversations with production managers, and limited to production costs, they are at best a rough estimate that firm economies of scale are not fully realized until a 5% market share is reached. However, the report does not indicate the difference in production efficiencies at the 1% and 5% levels or for points in between. Accepting the report at full value, it may be that, while firm economies of scale are fully realized at the 5% level, there is not a significant difference in firm efficiencies at the 1% and 5% levels.

630. Apart from the Headen-McKie report, the record contains no study or other direct evidence bearing upon economies of scale in the [179]RTE cereal industry. Complaint counsel attempt to support and further refine the conclusions reached by Headen and McKie by drawing inferences from other matters in the record.

631. First, complaint counsel (CPF 7-129 thru 7-133, 7-141) rely on the contention that RTE cereal manufacturers (Kellogg, General Mills and General Foods) with market shares above 5% were not more profitable than manufacturers (Quaker and Ralston) with market shares approximating 5%<sup>56</sup> and that there was no signifi-

<sup>55</sup> These considerations appear to have been made on a cursory basis (Tr. 26,864-65) and do not take into account other basic costs such as distribution and marketing. I cannot accept the Headen-McKie study as establishing that the only significant economies of scale are in production.

<sup>56</sup> Complaint counsel's argument is premised on rate of return figures which have been found to be unreliable (see, *infra*, Findings 676-799). Contrary to complaint counsel's contention, Quaker's rate of return was considerably lower than those of Kellogg and General Mills (*infra*, Findings 792, 797). Further, costs per dollar of sales would be a more appropriate consideration in evaluating economies of scale than returns on capital (Tr. 30,618).

cant disparity between market share movement of the firms in the two groups. It is contended that, if the larger firms had a cost advantage over the smaller firms, they would either have been more profitable or they would have expanded their sales and market shares at the expense of their smaller rivals.

632. There are many factors in addition to economies of scale that account for profits and market shares. These include differences in management decisions as well as differences in the products being manufactured. It may well be that the products of a particular manufacturer are selling at maximum consumer demand, that others are losing favor in the marketplace and that efforts to develop new products are meeting with varied success. Thus, under complaint counsel's own figures (CPF 7-132), General Mills' return on capital was well above the industry average, Kellogg's was slightly above average and General Foods' was below average. And, among the firms operating near the 5% share of market figure, Quaker's return was below average and Ralston's was above. These disparities using complaint counsel's own figures would show that there are many elements that impact profits other than share of markets.

633. There is simply no reliable way, on the basis of this record, in which company profits and market shares can be related to economies of scale to the exclusion of numerous other market factors (Tr. 23,799-801).

634. Complaint counsel (CPF 7-141 thru 7-144) next rely on instances where firms which were operating at the 1% to 3.5% market share level took steps to increase their market share to above the [180]3.5%-5% level. The contention is made that they did so in order to achieve economies of scale.

635. Complaint counsel (CPF 7-143) rely upon the fact that when Quaker dropped into the 1%-3.5% range in the early 1940's, it expanded its operations and remained above 3.5% into the 1950's; and that when its share again fell below 3.5% in the 1950's, it introduced new brands and undertook expenditures on plant, equipment and product development with the result that it brought its share to over 7% by 1971. A similar recitation is made of competitive efforts on the part of Ralston on the several occasions its share fell below 3.5%. Actually, Ralston continued to operate at below the 3.5%-5% rate during the periods 1943-1963 and 1966-1971 (Tr. 23,515).

636. All that complaint counsel have demonstrated is that when Quaker's and Ralston's business slipped, and profits correspondingly fell, they took steps to increase their business. None of the various Quaker and Ralston documents relied upon by complaint counsel

refer to or discuss economies of scale. They discuss sales volumes and profits to be realized through greater sales.<sup>57</sup> Quaker wanted to grow overall and accelerated new product development in most of the major businesses it was already in including RTE cereals, hot cereals, Aunt Jemima mixes, frozen foods, Quaker corn goods, Kennel Ration dog food and Puss'n Boots cat foods (Tr. 15,111-14). There is no evidence that this growth effort was stimulated by considerations of economies of scale in any particular area.

637. Complaint counsel (CPF 7-145 thru 7-157) next point out that, generally, individual plants of Kellogg, General Mills, General Foods, Quaker, Ralston, and Nabisco have capacities to supply over 4% of the market; that those which fell below that figure were either expanded or were closed. This, it is contended, supports the reliability of the Headen-McKie estimate and the conclusion that economies of scale in the RTE cereal industry are in the 3.5%-5% range.

638. The expansion of a small plant may well reflect increased demand for the particular products made there. The closing of a very small plant may be because it is no longer needed in the business. There may be all manner of reasons for these actions unrelated to economies of scale. Dr. Scherer, one of complaint counsel's expert economists, assigns very little weight to this technique (Tr. 26,934-[181]35). Dr. Glassman, through whom complaint counsel sought to develop the relationship between plant closings and expansions and economies of scale, conceded that motivations quite apart from minimum efficient scale could have been involved (Tr. 26,945-55, 26,983, 26,975-76). Plant closings and expansions, to the extent developed in this record, therefore, do not provide probative evidence on the question of firm efficiencies of scale.

639. Complaint counsel (CPF 7-159 thru 7-162) next contend that plant capacity utilization tends to be lower for smaller firms than for larger ones. This, according to complaint counsel, means that smaller companies build plants in excess of initial requirements in the hopes of expanding production to the point of reaching a 5% minimum efficient scale. There is no substance to this argument. Any competitor has hopes for a flourishing and growing business, and would build a plant on the basis of projected future demand.<sup>58</sup> Further, complaint counsel's assertion as to the relative utilization of capacity of larger firms vis-a-vis smaller firms is not supported by the records (Tr. 26,971-72, 27,001-02). General Foods' capacity

<sup>57</sup> Any firm realizing a normal or higher return on a particular volume of sales would consider increasing its sales if, without unreasonable risk, it could realize the same rate of return on the increased sales.

<sup>58</sup> Of course, to the extent a particular plant is operating below capacity, the firm, being subject to constant overhead costs, could be operating below minimum efficient scale.

utilization was relatively low and dropped as it lost market share (Tr. 26,364).

640. Finally, complaint counsel assert (CPF 7-163) that the evidence shows Procter and Gamble was considering entry into the RTE cereal industry, but that it would not enter unless it could acquire between 4% to 10% of the market; and that this confirms the reliability of the 5% Headen-McKie estimate. Mr. Butler, executive vice-president and vice-chairman of the board of Procter and Gamble, contrary to complaint counsel's contention, did not testify as to the market share Procter and Gamble would require to enter the RTE cereal industry; and there is no probative, reliable evidence on this issue elsewhere in the record.

641. In summary, under Headen-McKie, which does provide a rough estimate of production scale economies,<sup>59</sup> it would be economically [182]feasible to enter the RTE cereal market with production facilities capable of supplying about 1% of the national market. While the entrant could earn "satisfactory" profits at that level of production, it would not achieve full production economies of scale unless it supplied about 5% of the market. The study, however, does not indicate the degree of disadvantage that a firm would be under at various levels of production below 5% down to 1%.<sup>60</sup> Even if a firm required 5% of the market to achieve minimum efficient scale, it would enter at a smaller volume if the cost disadvantage was not too great. It is impossible, therefore, to evaluate the extent to which preemption of new entrants by reason of their inability to achieve economies of scale has acted to deter entry.

642. As noted above, Headen-McKie estimated production economies of scale, and in a cursory manner stated that other economies of scale were insignificant. As marketing and distribution fixed costs would appear to be considerable, it appears that Headen-McKie underestimated economies of scale in areas other than production. However, there is no reason to believe that the volume required to reach production economies of scale would not also satisfy the economies of scale of the other fixed costs. Further, the companies most likely to enter the RTE cereal industry would be food distributors and possibly large retail food chains which already have

<sup>59</sup> While expressed in terms of market share, economies of scale are determined by unit volume irrespective of the market share that volume accounts for (Tr. 23,024, 23, 038-39, 23,506, 23,508-09). The 1% and 5% market share figures in Headen-McKie were defined as 12 million and 60 million pounds per year, respectively (CX-CI 103Z-40). These market share figures remain a rough approximation, as RTE cereal industry sales increased only 14% from 1964, the date reflected by the Headen-McKie report, to 1972 (GFX 136). Economies of scale could also vary between firms to the extent their products, ingredients and technology may vary (Tr. 22,993).

<sup>60</sup> While various expert witnesses attempted to evaluate the extent of economies of scale at various levels below 5% (see, e.g., Tr. 23,027-29, 23,035-37, 23,517, 26,820-23, 26,827-28, 26,863, 26,870-71), there is no record or other referenced basis for such evaluations, other than an effort to construe the Headen-McKie Report.

their marketing and distribution systems (Complaint counsel's 1976 Trial Brief, Vol. I, ¶¶ 201.41, 201.43; Tr. 25,810, 25,848, 26,813, 26,836-42, 26,873, 36,839-40). Inasmuch as the Headen-McKie production economies of scale estimates were in terms of size of plant (CX-CI 103Z-40), it is unclear whether or not a food distributor could reach economies of scale by combining RTE cereal production with the production of other food products in the same plant. This reflects still further upon complaint counsel's failure of proof in establishing economies of scale for the RTE cereal industry. [183]

This failure carries over to the question of relief in the event of a finding of violation, where complaint counsel propose spin-offs to create firms capable of producing at least 5% of total industry output.

(b) Preemption By Reason of Anticipation of Retaliation

Complaint counsel (CPF 9-300 thru 9-307) assert that a potential entrant may be preempted from introducing a new product because of the belief that existing firms would be in a position to react more strongly against an outsider's new product than against new products of each other; that an outsider would seek a product having a larger share of the market in order to better resist such anticipated retaliation; and that while the potential entrant is delaying in seeking a larger opportunity, existing firms would preempt his entire endeavor by introducing their own products.

643. Complaint counsel's theory requires localization to the extent that an existing company's reaction can be limited to a narrow segment of the market. As previously found (Findings 59-150, 603), localization exists to an undefined, variable degree. The theory also requires significant differences between costs at the level of entry available to new firms and the level at which firm economies of scale can be achieved. This has not been established since there has been a failure of proof with respect to firm economies of scale.

644. Further, complaint counsel's theory is just that—a theory. There is no evidence of outside entry into a segment in which respondents have been located. Therefore, there is no evidence of reaction to such entry by an outsider; nor is there evidence of planned reaction to such an entry. The only contemplated entry into a segment occupied by existing companies evidenced by the record is that of Procter & Gamble, and that company expected no stronger reaction to its entry into the RTE cereal industry than to an entry into any other industry (Tr. 25,859).

### 7. *Proliferation By General Foods*

645. The introduction of new brands at a gradual rate which is sufficient to offset the gradual decline in shares of older brands is not anticompetitive and does not constitute brand proliferation. General Foods' pattern of brand introductions, in the face of a steadily declining market share since 1953, constituted that kind of product introduction activity aimed at recapturing a declining share of market. It did not constitute brand proliferation (Tr. 27,429-33, 27,468-69, 27,572-73; GFX 28, 1366). [184]

#### B. *Deterrences Other Than Brand Proliferation*

646. As defined by complaint counsel's expert, Dr. Schmalensee, "There is a barrier to entry if there is a difference or a lack of symmetry between the positions of existing firms and potential entrants, such that the existing firms can earn profits while the potential entrants would suffer losses" (Tr. 22,345). The definition was subsequently restated, "Barrier to entry is a factor or condition that makes possible, or more precisely, a factor or condition that makes the situations of existing firms in an industry different from the situation of potential competitors in such a way that the existing firms can earn excess or monopoly profits persistently, and yet entry will not be attractive." (Tr. 22,381).

647. Economists disagree as to what conditions of entry are properly classified as barriers (Tr. 22,388, 23,408). There are other conditions of entry which make entry more difficult but which both incumbent firms and potential new entrants are required to overcome. Because these conditions of entry do not present an asymmetry or difference between incumbents and potential entrants, they are not regarded as barriers to entry (Tr. 23,407-08). Even barriers to entry do not bar entry. They represent obstacles to be overcome, but entry deterrence is not inevitable (Tr. 22,384).

We need not concern ourselves with the differing opinions of economists as to which deterrents to entry are properly classified as barriers. We are concerned with the extent to which any conditions of entry explain the lack of new entrants into the RTE cereal industry.

Complaint counsel have contended that respondents' brand proliferation is the sole explanation for lack of entry in that industry. As I have found, complaint counsel have espoused a logical theory why brand proliferation (which is another term for competing by introducing new brands) would act to deter the introduction of products by new entrants. The extent to which lack of entry in the

RTE cereal industry may be so explained, however, is an unknown quantity because of a failure of proof of two elements upon which the theory rests. These are: (1) minimum firm efficient scale of entrance below which the new entrant would be at a competitive disadvantage to existing firms and (2) the degree of localization of RTE cereal products.

To the extent these two elements may have an impact on a potential entrant, brand proliferation may well exert a deterrence on entry. It is not, however, the only deterrence. [185]

648. Because of the high capital costs associated with entry, only large firms are realistic potential entrants into the RTE cereal industry (Tr. 17,559-60, 21,857-58, 22,676, 26,155, 26,258-60, 27,022-23, 27,009-10, 26,603; CX-CI 103Z-52; CPF 9-319). Based on complaint counsel's position as to production requirements to achieve minimum efficient scale, initial costs for plant, equipment and marketing would range from \$50 million to \$150 million (Tr. 21,857, 27,039).

649. Of those large firms, potential entrants would be further limited to those already in the field of grocery production and supply. This is so because firms look for opportunities where their established abilities can be utilized, not merely as an exercise of existing capability, but in order to cut down their overall costs of entering and operating in the RTE cereal industry (Tr. 25,809-10, 26,259; CX-CI 103Z-52). For example, a grocery firm with a diverse line could add RTE cereal using its existing sales force and distribution system (Tr. 22,998-23,000, 26,595-96, 26,813).

650. Even the limited number of potential entrants would be cautious about entering because of the high capital costs and the long lead times in recovering capital investments (CRP 7-65; Tr. 26,155). The existence of such long lead times to develop, test and market successful products has previously been found (Findings 552-57, 568-77, 600-01).

651. Obviously, faced with a long lead time for showing profits and recovering very high investments, a potential entrant must come up with a potentially overwhelmingly successful product, one that promises a relatively high rate of return (Tr. 22,420-21, 26,624; CX-CI 103Z-52-53). The problems in coming up with such a product are considerable, costly to overcome and time consuming (*supra*, Findings 552, 596, 650). They may well be insurmountable. Procter and Gamble, the only company evidenced to be interested in entering the RTE cereal industry (other than the granola segment), began by 1960 to consider whether to enter. It started its efforts to develop a product in 1964. By 1970, it had spent between \$500,000 to

\$1,000,000 only to determine that the product it had developed was not suitable. While still interested, Procter and Gamble has not introduced an RTE cereal product to this date (Tr. 25,803-05, 25,833-35, 26,898, 26,903; CX-PG 60).

652. Companies enter an industry only in anticipation of profits. However, a new entrant could not be assured that its product would receive consumer acceptance. As previously found (Findings 590-94), the failure rate of new products is high and a number of other products which remained on the market failed to earn satisfactory profits (CX-CI 103Z-52, Z-53, Z-54). While the industry rate of return and the rate of return of individual competitors is a complex matter (to be addressed in the next section) and a potential [186] entrant would be unaware (except for Kellogg)<sup>61</sup> of a company's rate of return on RTE cereal (Tr. 22,669-79), a potential entrant would be aware of a disparity of success among the various RTE cereal competitors. It would know, for example, that General Foods introduced 22 products from 1950 to 1977, but that only seven such products were still on the market in 1978 (Tr. 38,136). It would know also that General Foods' share of market grew only 1% from 1958 to 1966 compared to a gross national product growth rate of 4.9% (GFX 27). It would have observed General Foods' costly failure in its attempt to produce and market RTE cereals with frozen dried fruits (Tr. 36,382, 36,384, 37,181; GFX 1211, 1212; CX-GF 571). It would have observed General Foods' decline in market share from 25.3% in 1951 to 17.1% in 1973 and Nabisco's decline in market share from 12.5% in 1945 to 4.9% in 1973 (CX 106B). A potential entrant would not normally anticipate emulating the apparent success of the leading company, Kellogg (Tr. 26,554), but would be forewarned of risks by the experience of other competitors. And General Foods' growth rate and experience would indicate a degree of risk and lack of attractiveness for new entry (Tr. 27,420-21).

653. This observation of high risk would deter a potential entrant from entering the RTE cereal industry, unless it could foresee a rate of return higher than normal in order to compensate for the risk it would be incurring (Tr. 22,389-90, 23,237, 26,584, 38,517).

654. Entry must be made with a product that is perceived by consumers to be meaningfully different. "Me-too" products, products without significant differences, are likely to be failures (Tr. 9184-88, 12,965, 14,516-25, 14,584-86, 14,966-67, 15,228, 15,847, 15,851-53, 15,952, 17,453, 17,627-31, 17,634, 17,650, 22,720, 26,549; CX-K 396B). Since the introduction of presweets in 1950, nutritional cereals and

<sup>61</sup> Since Kellogg was almost entirely in the RTE cereal business, its reported profits would reflect its success in that industry.

then natural cereals, no products encompassing new basic concepts have entered the market (CX-GF 4010Z-2). Therefore, it takes a considerable amount of research and development, market research and basic know-how to come up with an acceptable product. With six major companies already experienced in the field constantly seeking to fill every new product opportunity, the difficulties of a would-be entrant to come up with an acceptable product are apparent. Witness the so-far unsuccessful efforts of Procter and Gamble. The extent to which companies already in the market have advantages over would-be entrants adds to the impediments to entry. The advantages vary in degree but, taken together, they may constitute a significant impediment to new entry.

655. The incumbents have the advantage of being in place with products that overall constitute a full line or lines (Tr. 26,554, [187] 26,760, 30,576). Not only do the existing products have an advantage over new products by reason of brand loyalty, but that brand loyalty carries over to new products of existing companies (Tr. 15,098-99, 15,165, 30,584-85).

656. Another advantage is the experience and technological know-how of insiders, not only as reflected in the individual capabilities of their employees, but as developed as a team or group effort.<sup>62</sup> New entrants do not have all of the skills of existing firms. It takes time to develop those skills. This is referred to as the learning curve. As cumulative experience is gained under the learning curve phenomenon, costs go down (Tr. 23,488, 27,321, 30,495-96, 30,542-43).<sup>63</sup> This is a disadvantage to new entrants which require time to develop necessary skills (Tr. 27,321, 30,543-44).

657. Even existing firms lack the know-how to produce certain categories of products and to duplicate some of the products of their competitors (Tr. 22,987-99, 32,995-96, 33,133, 33,209). This lack of know-how would be an even greater handicap to a new firm attempting to produce a targeted product. In building its second RTE cereal plant at Modesto, General Foods attempted to replicate the equipment it had in place at Battle Creek. Battle Creek engineers participated in the design of the Modesto plant. A Battle Creek foreman supervised training. Key Modesto personnel were sent to Battle Creek to work in that plant and gain as much experience as

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<sup>62</sup> Product and equipment development and maintenance, as well as production itself, at General Mills is accomplished by teams of personnel working together (Tr. 29,304-06, 32,786-87, 33,004, 33,219). Team leaders are promoted from the inside, but only from those who have had at least eight years of experience (Tr. 32,997, 32,999-33,000, 33,002-03).

<sup>63</sup> Employees of General Mills have been able, over time, to increase their productivity and reduce costs (Tr. 36,664, 36,670, 36,682-84).

possible. Battle Creek technicians supervised the Modesto start-up (Tr. 36,691-93). After nearly two years of operation at Modesto, General Foods obtained an output on the Raisin Bran/Bran Flakes line of 55.5% of the raw material input. This compares unfavorably with an 80% yield at Battle Creek (GFX 1347).

658. After three years of production, Ralston's Lancaster plant had a lower yield on flakes than Ralston's Battle Creek plant. Ralston attributes this to the lower level of experience and knowledge on the part of the Lancaster plant personnel (Tr. 10,693, 10,755-56).

659. The costs to Ralston in 1969 of producing its Chex products at its Cincinnati plant, after ten years of operation, exceeded the [188]costs of producing those products at Battle Creek, a plant built in 1928, by from 1.9 to 3.8 cents per pound. Yields were higher in Battle Creek than in Cincinnati (Tr. 10,693, 10,755-56, 23,489-91, 23,897). Ralston's Director of Production would attribute this difference to "experience, length of operation and personnel knowledge" (Tr. 10,756). Ten years would seem to be long enough to overcome all learning curve requirements. While I do not find that the learning curve phenomenon explains the lower efficiency of Ralston's Cincinnati plant, we do have these three instances where more recently built plants are less efficient than older plants of the same companies.

660. Manufacturing multiple products as they do, and with fluctuations in the success of particular products including failures, respondents frequently have excess capacity that they can use to manufacture new products (*see, e.g.*, Tr. 13,481; GFX 423C). Thus, whereas an insider need only consider operating costs, a new entrant would have to build capacity and cover both fixed and operating costs (Tr. 13,057-61, 13,481-83, 13,656, 13,994, 17,832-33, 23,090-94, 25,862, 29,890, 35,829-30; CX-GF 461, 4039G, Z-3 thru Z-4, Z-61 thru Z-63).

661. The only entry into the RTE cereal industry during the period covered by the complaint has been into the granola or natural cereal segment. Complaint counsel contend that entry was possible here since respondents had overlooked this segment, so that there was no brand proliferation which otherwise would have imposed a barrier to new entry.

662. Lack of existing competition certainly created a greater degree of opportunity for new entrants (Tr. 25,915-18). Entry into the granola segment, however, cannot be equated with entry into the remainder of the RTE cereal industry. Granola is a simple product to

produce. Very small manufacturers can produce granola on unsophisticated machinery,<sup>64</sup> without any research and development and with very low capital investments (Tr. 21,858, 23,471-72, 37,298, 37,300).<sup>65</sup>

663. By 1970, the granola segment accounted for 9% to 10% of the RTE cereal market (Tr. 29,678, 36,622). Competition existed among many companies, including Kellogg and General Mills which entered in response to the entry of others (Tr. 13,087-88, 17,802). [189]

664. Among those that entered the RTE cereal industry with natural cereal products were Pet, Pillsbury, Colgate and International Multifoods (Tr. 25,912-13, 26,487, 26,491-92). Pet was the most successful with its Heartland product which, at one time, attained a 2.1% market share (Tr. 22,934). These firms, after some initial success, all withdrew except for Pet which has become an insignificant participant (CX 434D). Carnation had been in the RTE cereal industry for some 20 years, but exited in the 1960's (KX 35). Pillsbury had previously exited in the 1930's and then again exited from the natural cereal segment in the 1970's (Tr. 26,334, 26,492). H. J. Heinz was in the industry in the 1930's and exited sometime prior to 1958 (Tr. 12,992, 26,489; KX 35). Potential entrants would have been dissuaded from entering the RTE cereal industry by the noted inabilities of these major grocery product companies to compete successfully (Tr. 26,511-13).

665. Respondents are charged with responsibility for lack of entry since 1950 when, it is alleged, they turned from price competition to brand proliferation. Yet, the industry was experiencing growth and respondents were flourishing in the 1940's and there was no entry during that period (Tr. 26,112; GFX 1366). Thus, no change in entry was effected by respondents' alleged change in competitive activity around 1950.

666. A growing market is normally an attractive one for entry since this reflects opportunity for a new product to share in the growth rather than simply try to take business away from existing products. Therefore, entry into such a market is less likely to provoke strong retaliation (Tr. 26,156-57).

667. For the overall period 1952-1966, RTE pound sales grew by 72.8% whereas the "all goods and services" Gross National Product ("GNP") grew by 63.9% (Tr. 26,158). However, for the period 1958-1966, RTE cereal pound sales increased 32.9% while the GNP went

<sup>64</sup> The manufacture of granola is so simple that it can be accomplished using the facilities of an existing bakery (Tr. 37,277).

<sup>65</sup> Organic Milling initially expended \$1,000 and then expended annual sales to \$1 million on additional expenditures of \$10,000. Sales reached \$3 million with total capital expenditures of some \$65 thousand.

up 42.1% (GFX 25). Further, the RTE cereal industry experienced a period of "no growth" from 1966 to 1970, which would have made entry into the industry relatively unattractive (Tr. 26,157-58).

### Summary

668. Respondents have engaged in intense, uncoordinated competition in the introduction of new products. This competition is not unlawful nor was it induced by other unlawful activity.

669. Obviously, the more successful new products introduced by respondents and other incumbents, the more saturated the market and the less requirement and opportunity for the introduction of new products by outsiders. By the very nature of differences in demand (*e.g.*, presweets, natural, fortified, bran, flavored), products are to be a degree localized, and a new product would to a degree be limited as to the segment from which it could attract its users. [190] Individual products account for lower market shares and smaller poundage of sales than formerly. The industry has become one of relatively small volume brands.

670. Incumbents are at an advantage over potential entrants in developing and marketing acceptable new products. They can utilize existing research and development, market research and other expertise in locating opportunities and developing products to meet perceived demand. They can also utilize unused capacity for production of a new brand, whereas a new entrant would have to build that capacity.

671. Respondents and other incumbents are not only capable of finding and taking advantage of an opportunity before a potential new entrant, but, because of economies of scale, are in a position to take advantage of smaller opportunities.

672. Would be entrants are faced with substantial fixed costs in research and development, market research, plant production equipment and introductory advertising. To the extent the requirement exists to introduce multiple products, the costs would multiply. Potential entrants, therefore, are limited to large firms, primarily those already producing and supplying grocery products who can utilize their existing expertise and so minimize costs of entry and operation.

673. The limited number of potential entrants would exercise caution in actually entering because of high capital costs, long lead times in developing and marketing acceptable products, extended periods even after entry in reaching levels of profitable operation and recovering capital investments, and the high risk that a product

may prove unacceptable at various stages up to national entry or may fail after entry. Indeed, the problems of developing an acceptable product with which to enter may be insurmountable.

674. While potential entrants would be aware of the publicly reported profitability of Kellogg, they could not hope to emulate the most successful company. Their desire to enter would be tempered by their observation of others in the industry. They would hesitate knowing of the failure of General Foods in marketing its cereals with fruit and its loss of market share, and of Nabisco's decline in market share. Potential entrants would also hesitate because of the observed inability of Pillsbury, Colgate, International Multifoods, and H.J. Heinz to remain in the market and the limited success of Pet.

As stated at the very beginning of this section, complaint counsel's theory of the existence of a barrier to entry into the RTE cereal industry is premised on the assertion that the industry has enjoyed supracompetitive profits and rapid growth; and that the absence of entry under these conditions indicates the existence of a barrier to entry.

675. While there was overall substantial growth from 1952-1966, growth from 1958-1966 was below that of the GNP and the industry was [191]in a period of no growth from 1966-1970. This leaves for determination the very first premise of complaint counsel's barrier to entry theory—the enjoyment by the industry of supracompetitive profits. I have left this opening premise until last since it falls within a very complex, highly contested set of issues involving industry performance. This will be dealt with in the next section.

## VI. PERFORMANCE

### A. *Economic Theory of Performance Espoused By Complaint Counsel*

As previously noted (pp. 22, 28-29), complaint counsel are relying upon a structure-conduct-performance analysis of the RTE cereal industry in their effort to show a violation of law. Findings on industry structure and respondents' conduct have already been made. This leaves an analysis of performance to which we now turn.

The following analysis of performance is derived from complaint counsel's introductory definition and explanation of that subject (CPF 11-1 thru 11-17). It shows preliminarily the burden of proof they have assumed.

*Performance.* This is the degree to which an industry serves the consumer and can be defined in terms of three major goals (Tr.

27,661). These three goals are: (1) to maximize the efficiency with which an industry and the economy overall operate; (2) to charge prices low enough so that excessive profits are not reaped from consumers ("equity"); and (3) to maximize producer progressiveness (Tr. 27,652, 27,661).

*Efficiency.* Competitive industries maximize efficiency in two ways. First, firms in an efficient industry will minimize their costs, and so avoid waste of production resources (Tr. 21,693, 27,655). The second form of efficiency is termed "allocative efficiency." When an optimal level of allocative efficiency is obtained, prices are kept at cost (including a normal rate of return), consumers demand and are able to purchase the greatest quantity of the good, and an optimal level of resources is devoted to production of the good (Tr. 21,695-96, 26,153, 27,652-54).

The economic law of demand is that the higher the price, the lower the quantity demanded of a good (Tr. 27,992-93). Whenever an industry prices above the competitive level, consumers demand less than they normally would, output is restricted and, thus, resources which should have been devoted to production of the good will be diverted to other goods. A misallocation of resources results (Tr. 21,692, 21,695, 21,707, 26,153, 27,652). Where there are excess profits, resources are being misallocated (Tr. 21,814). With free and open competition and prices kept at competitive levels, supply [192] and demand reach appropriate levels and consumers spend appropriate amounts for the good. In the absence of such free and open competition, consumers will spend lesser or greater amounts for the good and, correspondingly, will spend more or less on other choices. Thus, resources would be misallocated. The resultant losses when resources are misallocated are called "deadweight" or "welfare" losses (Tr. 27,999-28,000).

Consumers lose due to an industry's cost inefficiency. With competitive pressure, firms within a competitive industry strive to minimize their costs. When all firms minimize their costs, the industry's average level of costs goes as low as possible and the quantity of the product demanded by consumers would be at the greatest level that would permit firms to earn a competitive rate of return. However, in monopolistic industries, costs may be unduly high. For example, firms may be inefficient due to poor management, yet be able to survive because they are insulated from competition.

*Equity.* If an industry is performing equitably, neither prices nor profit levels will exceed those needed to attract the required amount

of capital to the industry. When prices, and therefore profits, are held unnecessarily high, income is being transferred unfairly from consumers to producers, consumers are injured, and performance is poor (Tr. 27,658-60, 27,991-92). Excess profits are earned whenever consumers must pay more for a product than is necessary to cover all the costs of distribution and production, including a "normal" return to the capital invested (Tr. 21,692, 21,707, 27,991-92). Persistent excess profits are evidence of poor performance and monopoly power (Tr. 21,790-91, 26,100-01, 27,991-92, 37,934).

Excess profits are also called "supranormal profits," "supracompetitive profits" or simply "monopoly profits" (Tr. 21,707, 26,090, 27,991-92, 37,934). An industry that reaps monopoly profits for a persistent period of time is said to be exercising "monopoly power" (Tr. 21,707, 26,081, 37,934). Monopoly profits show that consumers are being overcharged (Tr. 21,707, 27,991-92).

*Progressiveness.* Industries that perform well are progressive in taking advantage of new technological developments in order to increase efficiency. They also strive to offer superior new products and improvements of existing products to consumers (Tr. 27,655).

Underlying both equity and efficiency is the principle that the lower the price of a good, the greater will be the quantity demanded by consumers (Tr. 27,992-93).

#### Profits As A Measure of Performance

Performance is initially appraised by an analysis of profits. Economists commonly analyze profitability to determine an industry's level of performance (Tr. 21,692, 26,105). Monopoly power is the [193]ability of firms in an industry to hold prices above competitive levels (Tr. 21,707, 26,100-01, 27,934). Profitability is frequently examined to determine the existence of monopoly power, because if firms have been able to avoid competition, it is likely that profits will exceed competitive levels and will do so persistently over time (Tr. 26,100-01). Persistent high profitability indicates that competition has not been vigorous (Tr. 21,790-91).

Respondents take issue with many of the principles expounded and developed by complaint counsel that have been recited above. There is basic agreement, however, that the degree of respondents' and other industry members' profits is an important issue in this case, preliminary to reaching the other issues referred to above.

Initial Decision

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**B. Profits****1. Accounting Vis-A-Vis Economic Rates of Return**

676. Complaint counsel have elected to measure and evaluate profit in terms of rates of return on capital employed. This is an appropriate means of measuring profits for purposes of this case and is preferable to other measures, such as return on equity or return on sales (Tr. 19,069-71, 21,758-59, 31,288, 31,290).

677. Capital employed is the sum of all capital supplied to a firm by stockholders, in the form of equity or stock purchases, plus debt, such as bond issues; *i.e.*, total assets minus current liabilities plus the debt included in current liabilities (Tr. 19,160, 19,169-70, 20,172). Since the investment base in the accounting rate of return includes capital supplied by both equity and debt, the income measure or numerator of the ratio includes income or payments to both forms of investment. The income measure, therefore, is net income to the firm after taxes (the monies available for distribution to stockholders) plus interest on the debt included in capital employed (Tr. 19,070). This corresponds to a return on net assets.<sup>66</sup>

678. Economists and other business analysts have traditionally relied on accounting rates of return to measure both firm and industry profitability (Tr. 19,071, 21,698, 22,301, 31,373, 38,224-25). However, more recently, economists and financial analysts have [194]come to recognize serious shortcomings in the use of such accounting measures to judge firm performance, especially in certain industry settings (Tr. 19,045, 19,333-34, 26,106-09, 31,213, 37,954).

679. All of the economic experts who testified in this case agreed that accounting rates of return could be unreliable and misleading by overstating the profitability of a firm or industry (Tr. 13,336-41, 19,049, 19,332-36, 19,352, 19,361-62, 19,358-59, 19,987, 21,700, 21,705-06, 25,288-89, 26,116-18, 31,177-78, 37,493-94, 37,951-52, 38,182, 38,478-79). Dr. Stauffer, who was retained by the Commission to update its profitability analysis (Tr. 26,114-15), and who was its primary witness on the issue of profitability, was of the opinion that:

. . . rate of return as conventionally computed by accountants . . . is seriously in error, generally having an upward bias and thus overstating the economic rate of return of the firms (Tr. 19,987; KX 17, p. 97).

He believed that accounting rates of return can be quite imperfect

<sup>66</sup> This tends to understate Kellogg's asset base to a slight degree and so biases Kellogg's rate of return slightly upward relative to most other firms, since Kellogg is able to finance its operations through noninterest bearing liabilities (Tr. 31,284-85).

and significantly misleading by overstating profitability (Tr. 19,352, 19,358-59, 19,361); and that the biases would be most substantial in overstating rates of return for industries and firms that engaged in a lot of research and development and advertising and also where there were substantial time lags between investments and the receipt of returns on the investments (Tr. 19,336-41, 19,361, 25,288-89). As previously found, all of these conditions exist in the RTE cereal industry.

680. Recognizing the shortcomings of accounting rates of return, Mr. Michael Glassman, then Assistant Director for Economic Evidence of the Commission's Bureau of Economics, arranged for the employment of Dr. Stauffer who developed the economic rates of return relied upon by the Commission in this case (Tr. 26,101-02, 26,114-15).

681. The fundamental difference between an accounting and an economic rate of return concerns timing (Tr. 19,069, 19,332-33, 31,177, 37,951, 37,490). Timing relates to when moneys are spent by a firm, and when the incomes associated with those expenditures are received. The economic value of dollars received two years after investment is greater than dollars received five years later (Tr. 19,332-33, 19,336-41, 19,386, 38,478-79). Generally, the more lagged the cash flow of receipts relative to the cash flow of expenditures, the higher will be the disparity between the accounting rate and the economic rate (Tr. 31,178). Nevertheless, a dollar is recorded as a dollar in the books of account of a company regardless of the length of time between the investment and the receipt of money that is generated (Tr. 37,951).

682. Accounting and economic practices differ with respect to timing of both expenditures and receipts (Tr. 19,332-33). These [195] timing differences frequently are associated with the different practices of accountants and economists with respect to advertising, research and development and depreciation (Tr. 19,069, 19,333). Timing differences can result in an accounting rate of return that is not an accurate measure of the economic rate of return (Tr. 31,177-78).

683. The difference between accounting and economic rates of return is illustrated by an example in the record of a firm which produces whiskey, which it ages for eight years. If it is assumed that it costs the company \$1 to prepare a barrel of whiskey which the firm sells eight years later for \$2, the firm makes \$1 of accounting profits at the time of the sale. The accounting rate of return for the transaction is 100%, based on an original investment of \$1 and the profit of \$1. An economist views the transaction differently. An

economist would ask at what interest rate one could have invested the \$1 to yield \$2 eight years later. The economic rate of return is that interest rate. Thus, in this example, the economic rate of return is 9.05%, because if the distiller had invested \$1 at 9.05%, he would have had \$2 at the end of eight years.

684. In the example, the economic rate of return was 9.05% because that interest rate would yield \$2 on a \$1 investment in eight years. More technically, the economic rate of return is defined as the rate of discount (interest rate) under which the discounted present value of all cash inflows over the full life of a firm's investments is equal to the discounted present value of all cash outlays (Tr. 19,340-41, 31,171-72, 37,489-90, 37,944-46).

685. There may also be differences between accounting and economic rates of return caused by the accountant's treatment of research and development, advertising and depreciation (Tr. 19,333).

686. Accountants treat all research and development ("R&D") as a current expense (Tr. 19,342, 19,504). This means that, in computing profits, all expenditures on R&D are deducted as expenses from the firm's total revenues in the year in which the money is spent. R&D is similar to fixed assets, however, in that it generates revenues for the firm over future periods of time (Tr. 19,342-43). The accounting treatment of R&D may cause a distortion in the true rate of return because today's income is being charged for expenses that produce benefits in the future (Tr. 19,342-43).

687. Advertising expenditures also may cause differences between the accounting and economic rates of return (Tr. 19,333). Advertising has some effects which occur quickly, but it also has effects that are longer lived (Tr. 19,359-60). Some of the effects of advertising will be realized in the same accounting period as that in which the expenditures are made (Tr. 19,359-60). However, a portion of the benefits will occur in future accounting periods (Tr. 19,360, 26,106-07). Accountants treat all advertising as a current expense, charging it all to the year in which it is incurred, even though it may benefit future years (Tr. 19,360). To the extent that the revenues or benefits generated by advertising do not occur [196]in the same year as the advertising expenditure, an accounting rate of return does not provide an accurate measure of the economic rate of return (Tr. 19,361).<sup>87</sup>

688. Depreciation practices are another source of difference between accounting and economic rates of return (Tr. 19,333, 19,362-

<sup>87</sup> In addition to R&D and advertising expenses, portions of expenditures relating to market research, test marketing, promotions, establishment of a distribution system and quality control, are of a quasi-capital nature and their treatment as 100% immediate expenses on books of account tends to overstate true rates of return (Tr. 25,322-25, 25,332-33, 26,574-77, 29,852, 37,622-25, 37,712).

63, 21,701-02, 31,191-95). Depreciation is the cost to a firm associated with "using up" an asset purchased by the firm to generate future income. This means that if a firm purchases a machine at a given point in time it must subtract from its revenues a charge for using up (depreciating) that investment over some period of time (Tr. 19,363).

689. Accounting depreciation is determined by accounting conventions which are based on convenience, uniformity or other considerations apart from economic significance. Economic depreciation is a function of future cash flows (Tr. 19,362-63). Since accounting conventions do not necessarily (or even usually) reflect the actual timing of the benefits received from an investment in fixed assets, a bias in the accounting rate of return results (Tr. 31,195).

690. Accounting rates of return distort true rates of return because of the accounting conventions associated with depreciation. Accountants have conventions for stating the estimated life of investments which may or may not correspond to the true or economic life of the investment. They then amortize the amount of the original investment over its estimated life in form of depreciation expense. The economist, on the other hand, is interested in the true investment life and the amount and pattern of cash flow generated by the investment over time (Tr. 19,362; CPF 11-66). Cash flow does not include a deduction for depreciation (Tr. 19,366, 19,373, 19,376, 19,394, 21,701-02). Only under very special circumstances would accounting and economic depreciations be the same (Tr. 19,362).

691. One reason for the difference results from the rules used for tax depreciation purposes. Firms have been permitted by the IRS to take more rapid depreciation for tax reporting than they would for normal bookkeeping purposes. Firms use various accelerated depreciation formulae for tax purposes. In general, firms use accelerated depreciation because it is in their interests to use the most rapid depreciation schedule allowable under the tax code [197](Tr. 19,363, 19,409-10). Again, this accounting convention of understating the true life of a fixed asset overstates the economic rate of return on investment.

692. Taking particular note of the large capital investments, the extremely high rate of advertising, the extensive amount of R&D and the long delay in securing a return on investment,<sup>68</sup> I find that

<sup>68</sup> The larger the magnitude of such expenditures and the longer the delay in securing a return, the larger the bias in the accounting rate of return, i.e., the more the accounting rate of return is greater than the economic rate of return (Tr. 25,363, 37,621).

economic rate of return, not accounting rate of return, is the appropriate measure to be used in appraising profits enjoyed in the RTE cereal industry and in making comparisons among respondents, with other companies and with other industries.

## 2. *Methodology Of Computing Economic Rates Of Return*

693. The economic rate of return for a project can be measured if one knows how much has been invested in it and can identify and measure the cash flows or benefits associated with the investment. Thus, if one knows, for example, that a company has invested \$100 in a particular project and that the cash flow generated by that project is \$30 a year for ten years, the economic rate of return can be computed from tables or by calculation. The formula for the economic rate of return for a single project is widely used by bankers, economists and insurance brokers (Tr. 19,366-72).

694. The determination of the economic rate of return for an ongoing firm, which may be viewed as a collection of projects, is a much more complicated matter. Dr. Thomas R. Stauffer has devised a formula to make such a determination. This formula is a pioneering contribution in the field and was the subject of Dr. Stauffer's doctoral dissertation in economics at Harvard University. Other doctoral dissertations in economics at Harvard have applied his formula in the analyses of specific industries (Tr. 19,373, 19,378-79, 19,385, 21,759-64). This formula was applied by Dr. Stauffer in the instant case.

695. Dr. Stauffer's formula starts with an accounting rate of return and from it calculates an economic rate of return. It is necessary to know the investments a firm has made and identify the cash flows associated with those investments. However, as noted above, there are accounting conventions that govern the way a firm's accounts are set up, as well as accounting rules which govern tax liabilities which, in turn, affect the firm's accounts. [198]Dr. Stauffer's formula takes into account various accounting conventions and tax rules and makes certain assumptions, including that of the pattern of cash flows (Tr. 19,374-79; CX 702B).

696. Dr. Stauffer's calculation of the economic rate of return involves an equation which has four terms, the sum of which equals the accounting rate of return. Each term of the equation takes into account, and adjusts for, potential biases in the accounting rate of return. There is a "base" term which deals with the firm's investment in fixed assets and working capital, terms relating to advertising and research and development, and a term which

corrects for the difference between corporate and tax accounting rules (Tr. 19,379-82, 19,485-87; CX 702C, M).

#### The Base Term

697. The base term in the equation reflects the contributions to the income of the firm generated by investments in fixed assets, such as plant and equipment, and working capital such as cash and inventories (Tr. 19,491). Estimates were made as to how long assets would earn income for the firm. These estimates were necessary because they relate to the timing of revenues associated with investments. This "service lifetime" is included in the base term. The average service lifetime of assets purchased by a firm was calculated by Dr. Stauffer from data available from each firm's books of account (Tr. 19,411-15, 19,442-49, 19,451-54; CX 702G-H).

698. It was also necessary to assume the average time interval between the investment in fixed assets and inventory, and the first generation of revenues from the investment (Tr. 19,406, 25,576). This lead time assumption is the average for all types of assets, including assets with short lead times such as inventories, automobiles and typewriters (Tr. 19,406-09, 25,576, 25,580).

#### The Research and Development Term

699. The second term of Dr. Stauffer's economic rate of return equation relates to the contribution of research and development to income. It is intended to correct for the bias in the accounting rate of return caused by the accounting treatment of R&D as a current expense (Tr. 19,342-43, 19,504-05, 19,508; CX 702 O). As part of the R&D correction, it was necessary to make an assumption concerning the time interval between the expenditure of funds for R&D and the first receipt of revenues associated with those expenditures (Tr. 19,424-25, 19,510-11).

#### The Advertising Term

700. The third term in the economic rate of return equation relates to advertising. It reflects the contribution of advertising [199] to accounting income (Tr. 19,520, 19,485-86; CX 702C, M). This correction was necessary to account for the revenue and income for the firm generated by advertising for a period extending beyond the year in which the expenditures were made and were deducted from accounting income (Tr. 19,360).

### The Depreciation Term

701. The fourth term in Dr. Stauffer's formula adjusts for differences caused by the accounting method of treating depreciation (Tr. 19,380, 19,540; CX 702C, Q). The term takes into account the economic value of the timing difference which results from the use of a more rapid depreciation schedule for tax purposes than the schedule used for book purposes. The formula corrects for the effect on the accounting rate of return of the difference between tax depreciation and book depreciation (Tr. 19,412, 19,544-45).

### The Cash Flow Profile

702. Since the pattern and timing of cash inflows earned by a firm plays an important role in calculating the economic rate of return, in order to calculate the economic rates of return, Dr. Stauffer made assumptions concerning the actual pattern of cash inflows earned by each company (Tr. 19,386, 24,942-44). The assumed pattern of cash inflows is called the cash flow profile assumption and is included in each of the four terms of the equation, (i.e., 1. base term; 2. R&D term; 3. advertising term; and 4. depreciation term) (Tr. 19,495, 19,514, 19,525, 19,541).

703. Two alternative shapes were assumed by Dr. Stauffer for the cash flow profile: the triangular and the rectangular (Tr. 19,387, 24,944-47). These names reflect the shapes of the graphs of the annual cash flows for the two assumptions (CX 702D). The two shapes were chosen as upper and lower bounds for the cash flow profile. The actual cash flow profile, according to Dr. Stauffer, lies somewhere in between these two extremes (Tr. 19,386-87, 19,394-96, 24,944-47, 24,954). The underlying assumption for a rectangular cash flow profile is that the cash flow produced by an asset is the same in each year for the entire life of the asset. The assumption underlying the triangular cash flow profile is that the cash flow produced by a new asset starts at a high level, and declines steadily over the life of the asset (Tr. 19,394-95, 24,944; CX 702D). The shape of the cash flow profile had to be assumed, rather than calculated, because Dr. Stauffer could not directly ascertain its shape from available data (Tr. 19,397).

While respondents uniformly agree that Dr. Stauffer's formula for reaching economic rates of return is much superior to relying upon an [200]accounting rate of return analysis, they do object to a number of Dr. Stauffer's inputs into his formula. The first objection is to the accounting data used by Dr. Stauffer.

(a) Accounting Data Allocations

704. The first, and very critical, step in reaching an economic rate of return is to segregate and allocate the accounting data (assets, liabilities, costs and expenses) that pertain to the RTE cereal business of the company being studied (Tr. 20,166).

705. General Mills, General Foods, Quaker and Ralston are engaged in various lines of business in addition to RTE cereals. Expenses were incurred and assets employed in the joint or common support of two or more of these lines of business without allocation by those companies to the particular businesses. For example, the records of General Mills show only operating profits based upon operating costs which include such activities as manufacturing, distribution, advertising and selling. These operating profits are before any charges for interest, taxes<sup>69</sup> and a group of costs called unallocated corporate expenses. Major items included in unallocated corporate expenses are salaries of the top officers of the company, executive incentive payments to such officers, contributions and airplane operations and maintenance (Tr. 18,154, 18,173, 18,265, 18,275; CX-GM 2486D). Similarly, these firms did not maintain records showing the portion of balance sheet values for all assets associated with their RTE cereal business (Tr. 18,178-89, 18,301-02, 18,305; CPF 11-21).

706. Identifying the accounting data that is applicable to RTE cereal is important because the accounting data chosen is one of the most influential inputs to Dr. Stauffer's economic rate of return calculations. Inasmuch as General Foods, General Mills, Quaker and Ralston have substantial joint assets, liabilities, costs and expenses which are not broken down by business endeavor,<sup>70</sup> it was [201] necessary to allocate to the RTE cereal business an appropriate portion of those items. Those allocations had to be made by means of estimates (Tr. 18,148, 20,166).

707. The following discussion of allocations will be limited to General Mills and General Foods since Kellogg's, Ralston's, and Nabisco's accounting data were not analyzed by Dr. Mellman and

<sup>69</sup> Similarly, since General Foods pays taxes on a company-wide basis, it has no need to develop such figures as "accrued taxes payable" or "provisions for income tax" solely for its RTE cereal operations (Tr. 16,299). Yet, such figures are necessary to obtain RTE cereal line of business data which is as complete and accurate as possible for comparison with other companies.

<sup>70</sup> For example, in 1972, corporate interest and unallocated corporate expenses amounted to 42% of General Mills' total corporate consolidated earnings before tax (CX-GM 2486). The rate of return estimates, therefore, are highly sensitive to the amount of these expenses allocated to the RTE cereal operation.

Kellogg's business during the complaint period was virtually all RTE cereals. Thus, allocations of joint costs and assets were unnecessary to arrive at its RTE cereal accounting rate of return (Tr. 12,036-37). The minor adjustments that were made to Kellogg's accounting data by complaint counsel's accounting expert, Dr. Mellman, are not challenged (Tr. 20,171-72; KPF 5-71).

allocations of Quaker's figures amounted to only .03% on its accounting rate of return for years 1956-1972 (CX 701M).

708. There are no uniformly accepted accounting principles for allocating joint and common costs, expenses, assets or liabilities to individual segments of a business (Tr. 20,599). The President of the National Industrial Conference Board has concluded, "It is evident from the multiplicity of plans uncovered by this year-long study that there is no one best method of allocating central expenses. What is desirable in one situation sometimes proves to be inadequate or misleading in another" (Foreword to C. Baumes, *Allocating Corporate Expenses*, National Industrial Conference Board, Inc. (1963)). Among those in common use are sales dollars, sales units and costs (Tr. 38,024-25; GFX 1332Z-132).

709. The Federal Trade Commission's Bureau of Economics has indicated that it will use a variety of allocation bases in processing line of business data:

In processing the LB data, the FTC staff will apply plausible, alternative non-traceable cost allocation rules—e.g., allocation according to sales, assets, payroll, and contribution margin [profits]—and test the sensitivity of calculated operating income figures to those alternatives (Bureau of Economics Staff Memorandum - 1974 Form LB Revision, at p. 5).

710. When detailed information on the make-up of a joint cost is unavailable, allocation methodologies are necessarily somewhat arbitrary (Tr. 21,036-52, 28,715-17). [202]

711. All parties agree that the standards published by the Cost Accounting Standards Board (CASB), Section 403 (4 C.F.R. 403), which relate to accounting standards for government contracting, constitute an appropriate guideline for use here (Tr. 20,162-64, 35,907-08; CPF 11-34; KPF 5-78, 5-79; GMPF 3-48).<sup>71</sup>

712. CASB Section 403 provides that any home office expense that is directly identifiable with particular segments should be allocated directly to those segments. For the residual, the allocation should be based, to the maximum extent possible, on cause/effect relations. If after making that allocation, there is still a residual, that residual should be allocated on the basis of a surrogate for causal or beneficial relationships. If after that allocation, there still remains a residual, the standard provides that a three-factor formula should be used to allocate it. The three factors consist of payroll dollars, operating revenue [sales dollars], and tangible

<sup>71</sup> A Bureau of Economics staff memorandum accompanying the Commission's Line of Business reporting form suggests use of CASB standard 403 (Bureau of Economics Staff Memorandum—1974 Form LB Revision, at p. 5).

capital assets plus inventories (Sections 403.20(a), 403.40(a)(1); Tr. 35,907-09, 35,923-26).<sup>72</sup> CASB 403.50(b)(1)-(2) (4 C.F.R. Section 403.50(b)(1)-(2)) provides in part:

. . . The allocation of centralized service functions shall be governed by a hierarchy of preferable allocation techniques which represent beneficial or causal relationships. The preferred representation of such relationships is a measure of the activity of the organization performing the function. . . . (2) Where neither activity nor output of the supporting function can be practically measured, a surrogate for the beneficial, or causal relationship must be selected. Surrogates used to represent the relationship are generally measures of the activity of the segments receiving the service. . . . Any surrogate used should be a reasonable measure of the services received and, logically, should vary in proportion to the services received.

713. The CASB has recognized that a cost basis is an appropriate surrogate for the activities managed, including general and [203] administrative expenses, under certain circumstances (CASB 410, 421; 4 C.F.R. 410.106-410.50, 421).

714. It is clear, therefore, that there are a number of alternative cost accounting methods for allocating joint assets, liabilities, costs and expenses, and that none of the methods has been authoritatively declared to be superior to any of the others. Certainly, none has been dictated for use to the exclusion of the others. Of course, in individual cases under particular circumstances, it may be demonstrated why a specific method of allocation is superior to alternatives or should be used to the exclusion of all others. This has not been demonstrated here; and the burden of doing so was on complaint counsel. All that the parties have done is to advance general reasons, not related to the specifics of this case, why one method should be preferable to another. All of these reasons ostensibly have been advanced to and considered by CASB (as well by the National Industrial Conference Board) and that board has seen fit to issue general guide lines which, in my opinion, allow all of the methods of allocation advocated by the various parties here.

715. Under these circumstances, there is a lack of proof that the allocations advocated and introduced by respondents are improper; and respondents are entitled to have those allocations utilized in arriving at accounting rates of return for their RTE cereal businesses. These allocations, in turn, are the ones to be used in Dr. Stauffer's formula for arriving at economic rates of return.

More detailed findings covering the several allocation methodologies of the different parties follow.

<sup>72</sup> This formula could not be used here because of insufficient payroll and tangible asset data. In any event, sales dollars is recognized by CASB as having a controlling impact.

Dr. Mellman's Method  
(The Method Contended For By Complaint Counsel)

716. Dr. Mellman did not reallocate costs and expenses, or assets and liabilities, where the RTE cereal company's original assignment was direct and not allocated, because there can be no improvement on a direct assignment (Tr. 20,169). Thus, for example, advertising expenses were not reallocated because advertising was charged directly to the brand for which the advertisements were run.

717. Dr. Mellman recognized that to determine the profits of a business segment, such as the RTE cereal segment of a diversified corporation, an effort basis is the best way to allocate expenses to segments where the information is available; that expenses should be allocated in proportion to how efforts were actually applied, because it reflects the way resources were used by that segment; and that effort can be measured on a number of different bases. For example, in allocating such expenses as the salary of a division manager who is responsible for products in more than one segment, an effort basis might allocate the associated expenses according to the amount of time spent in supervising the segments under his control. [204]Thus, if the manager spends 40% of his time supervising one of two segments, 40% of the expenses associated with the manager, such as his salary, would be allocated to that segment (Tr. 20,158-60). Respondents would agree with Dr. Mellman up to this point.

718. When detailed data on effort are unavailable, an alternative basis of allocation must be used. Dr. Mellman was of the opinion that the most reasonable approximation of an effort basis, in the absence of detailed information on effort, is generally cost (Tr. 20,158, 20,164). The cost basis allocates expenses to the segments in the same ratio as direct expenses have been incurred by those segments (Tr. 20,161).

719. An example would be a division manager supervising two segments, A and B, and the absence of records which show the actual time spent (the actual effort) supervising the two segments. Assume that 40% of the total direct costs of activities managed by the division manager are generated by segment A. These costs include materials used, labor, overhead, marketing costs, promotions, selling expenses, and so forth. In the absence of detailed information on the time spent working on each segment, 40% of the division manager's cost would be allocated by Dr. Mellman to segment A. The assumption underlying this method of allocation is that the division manager would allot his time in accordance with the relative

activities of segments and the 40% share of costs attributed to segment A would reflect its share of total activity supervised by the division manager (Tr. 20,161-62).

720. Professor Mellman also used a cost basis to allocate assets and liabilities. He recognized that, ideally, allocations of assets would be based on actual usage of the assets allocated. Thus, for example, a warehouse might be allocated based on the square feet of space used by each segment. However, such a basis would require detailed information about the way in which an asset was actually used (Tr. 20,167). In the absence of such detailed information, Dr. Mellman used a cost basis for the same reasons he used a cost basis for allocations of expenses. In the illustrative example of the division manager, the assets such as the office used by the division manager would be allocated in the same proportions as his expenses. Thus, if 40% of his expenses were assigned to segment A, 40% of the assets he used would be assigned to the segment (Tr. 20,167-68).

721. Applying the same principles, a cost basis was used in the assignment of liabilities, whereunder liabilities are allocated according to ratios of the expenses related to that liability. For the division manager described above, there would be a liability shown on the company's books for salary owed to him but not yet paid. Under a cost principle, that liability would be allocated in the way in which the division manager's costs were allocated, inasmuch as liabilities are costs and expenses that are incurred but not yet paid (Tr. 20,169-70).

722. Of course, division costs do not necessarily reflect corporate activity and the utilization of corporate assets. [205]Relatively costly modern equipment may relieve the division manager of time consuming exercise of responsibility, and the cost may not at all reflect the share of warehouse space occupied.

723. The cost of effort or activity that is to be allocated is that at the corporate level, not at the division level. No necessary relationship exists between expenses at the corporate level and costs at the division level. The two levels involve different groups of people doing different things (Tr. 35,907-15).

724. Costs at the division level include outlays for raw materials. At General Mills, for example, roughly 75% of the costs of RTE cereal sales were ingredient costs (Tr. 18,272). Changes in the price or composition of raw materials are unrelated to changes at the corporate level. Depreciation is a significant cost item at the division level. There is no plant and equipment at the corporate level (Tr. 35,912-13).

725. Executive incentive payments are an item of unallocated

corporate expense. Such costs are inversely related to operating costs such as manufacturing, distribution and marketing inasmuch as the amount of executive incentive payments increases with the amount of corporate profits. Thus, as costs rise, profits decline and incentive payments would decline (Tr. 18,267, 18,269, 18,342-43).

726. Professor Mellman allocated cash and marketable securities on the basis of total segment operating costs plus interest, taxes and unallocated corporate expense, on the ground that cash is used to pay for costs and expenses (Tr. 20,549, 20,799-803). However, cash and marketable securities, as they appear on the General Mills balance sheet as of the end of its fiscal year, for example, are a function primarily of profits. They would appear to be inversely related to costs inasmuch as the higher the costs, the lower the cash on hand and the cash temporarily placed in short-term marketable securities (Tr. 18,326, 35,920-22).

727. Application of Dr. Mellman's costs basis allocation formula resulted in a range of General Mills' ratio of allocation of from 10% to 18% from year to year (Tr. 20,794-97), a substantial variation without apparent explanation. It would also result in an exceptionally low ratio between current assets and current liabilities for General Mills' RTE cereal segment. This is one measure of the financial soundness of a firm. Professor Mellman allocation so little of the unallocated corporate assets to General Mills' RTE segment that the segment has an average current ratio of only 1.4 for the period 1958-1972 and only 1.0 in 1965, 1.2 in 1971 and 1.1 in 1972 (Tr. 20,925-30; GMX 58, 472). These General Mills ratios are substantially lower than those for Kellogg, General Foods, Quaker and the Internal Revenue Service group of manufacturing firms which compliant counsel use as a profit "benchmark." Indeed, the General Mills ratios are lower than the ratio for the firms in the IRS sample that suffered net earning losses (GMX 58, 472). Such ratios would be unrealistic for a General Mills RTE cereal segment which is alleged by complaint counsel to have been very profitable (Tr. 35,111). In addition, Dr. Mellman's allocation to RTE cereal of [206] General Mills' corporate unallocated expenses decreased by one-third from 1967 to 1972 despite the fact that sales and profits increased by 30% (Tr. 21,110).

728. The above analysis of a cost allocation approach and its application to General Mills' and General Foods' operations indicates why such a method of allocation cannot be found to be the only or a superior method of allocation to be utilized in this case. Dr. Mellman has conceded that his cost allocations may well vary from

what an actual measurement of the breakdown of a joint effort might show (Tr. 20,893, 20,905, 21,524).

#### General Mills' Method of Allocation

729. General Mills' expert, Mr. Troxel, used profits as the primary basis for allocation (Tr. 18,266-72, 18,302-05, 18,325-26, 18,342-43), although some items were allocated on the basis of sales (Tr. 20,830-33; CX-GM 2486). As previously indicated, there does appear to be a causal relationship between profits and incentive payments since incentive payments are normally based on profits (Tr. 18,266-67, 18,269, 18,342-43, 35,909). The same causal relationship appears to exist between profits and cash and marketable securities (Tr. 18,325-26, 35,920-22). Inasmuch as taxes are a direct result of profits, the allocation of accrued taxes on a profit basis also appears appropriate (Tr. 18,323).

730. Just as with Dr. Mellman's cost basis of allocation, Mr. Troxel's profit-sales basis has its obvious failings. Since sales figures include an element of profit, allocations based on sales reflect, in part, a segment's ability to bear costs rather than the effort or resources expended. Furthermore, there are numerous factors that affect selling price, and there is not necessarily a relationship between selling price and cost or usage (Tr. 20,164-65).

731. For reasons similar to those applicable to allocations based on sales dollars, a profit basis reflects the ability of a segment to pay or bear the allocated costs, rather than effort or activity (Tr. 20,165). The most obvious failing of a profit margin basis of allocation, however, is that, if a segment has zero profits, it would get no allocation of corporate expense; and if it had a loss, it would actually receive a negative allocation, despite the fact that corporate headquarters might have been devoting an inordinate amount of work in an effort to turn the unprofitable segment around (Tr. 20,166, 20,168-69). Further, a profit basis of allocation would result in allocation revisions reflecting changes in profits, irrespective of the flow of services (Tr. 20,793).<sup>73</sup> [207]

732. Nevertheless, sales and profit bases of allocation are acceptable under statements issued by the Commission's Bureau of Economics and under CASB standards, and are no less acceptable than the cost basis utilized by Dr. Mellman.

733. Further, in the Bureau of Economics' staff memorandum attached to the Commission's Supporting Statement to its 1974 Line

<sup>73</sup> The lack of complete reliability of a profit basis of allocation is thus demonstrated; and it is immaterial that no segment of General Mills showed a loss on the basis of a five-year moving average of profits (Tr. 35,927-29).

of Business reporting form, it was stated "that the reporting companies are in a better position than the FTC staff or anyone else to make them [allocations]" (at p. 5). Normally, substantial weight would be given to allocation procedures if they were utilized by a company in the normal course of its business. While the allocations relied upon by General Mills were prepared by an outside consultant for purposes of this case (Tr. 18,150), they are nevertheless entitled to the same presumptions of correctness they would be entitled to in Line of Business reporting.

#### General Foods' Method of Allocation

734. General Foods' established cost accounting system assigned any expense or revenue that could be directly identified with a particular product or brand directly to that product or brand. Residuals were allocated based on formulas prescribed throughout the corporation. Within divisions that contained homogeneous units, the allocations were based on unit sales. Where not homogeneous, the residual was normally allocated on the basis of a fifty-fifty average of unit sales and gross dollar sales (Tr. 16,277, 16,333, 38,020).

735. The figures used were taken from the basic accounting records of General Foods, used by it for operations and decisionmaking purposes in the regular course of its business. The basic data was not prepared for purposes of this litigation. Existing records were utilized and methodologies used by General Foods in the ordinary course of its business were employed (Tr. 16,230, 38,016-17).

736. Under the previous discussion of criteria for an allocation system, General Foods' method certainly qualifies as an acceptable method and there is no reason to believe that any alternative method would be preferable (Tr. 37,924-32, 38,016-17).

737. Not only does the presumption of preferability for a company's own method of allocation apply, as stated in the Bureau of Economics' staff memorandum accompanying the Line of Business reporting form, but General Foods' method was one used in the regular course of business and so is entitled to the presumptions normally accorded such business procedures.

738. General Foods' cost accounting system has already been the subject of hearings *In the Matter of General Foods Corporation*, Docket No. 9085. In that case, Professor John Dearden, a professor of accounting at the Harvard Business School, was called as an expert witness by complaint counsel (Tr. 38,021-22). In analyzing profit [208]calculations, Professor Dearden reviewed General Foods' ac-

counting and financial manuals and concluded that General Foods has an excellent cost accounting system and that there was nothing he would, as a cost accountant, want to change (Tr. 38,023-24; GFX 1332Z-10, Z-11, Z-131).

739. Professor Dearden's opinion was that General Foods' allocation procedures, while a matter of judgment, were "not capricious"; that they constitute a good and sound way of making allocations; and that there is no better way (Tr. 38,025-26; GFX 1332Z-220, Z-221).

740. Thus, General Foods' cost accounting system has been presented by the Commission's staff as highly reliable in the other case involving General Foods. Complaint counsel cannot merely turn their backs on this position.

741. Complaint counsel (CRPF 11-28, 11-29) agree that Professor Dearden's testimony in Docket 9085 should be limited to General Foods' Maxwell House Division which was directly involved in that case; that "[i]f Professor Dearden had testified in the RTE cereal case, he might have explained that there are differences in the situations that make his testimony in the 'Coffee' case inapplicable to the RTE cereal case." An examination of Professor Dearden's testimony, however, indicates that his commendation of General Mills' cost accounting system went to the system as a whole and was not inapplicable to RTE cereals. If complaint counsel were of the opinion that Professor Dearden would have limited and distinguished his testimony had he testified in this case, it was complaint counsel's obligation to have called him as a rebuttal witness. They did not.

Respondents assert (GFPPF 5-70, 5-71, 5-85 thru 5-128; KPF 5-92, 5-93; GMPF 3-51) that Dr. Mellman has made a number of errors in applying his allocation formula. These assertions include alleged utilization of allocation ratios when direct assignments were possible, utilization of improper and inconsistent ratios, improper "grossing-up" from segment figures to corporate figures, improper and unsupported assumptions and failure to make certain adjustments. Complaint counsel (CRPF 11-38 thru 11-42) defend Dr. Mellman's "grossing-up procedure" as reasonable, and otherwise purport to justify Dr. Mellman's procedures. Apparent errors are asserted to be insignificant (CRPF 11-43 thru 11-59).

Inasmuch as respondents are entitled to rely on the more favorable allocation procedures utilized by General Mills and General Foods, it would serve no purpose to resolve the numerous issues raised regarding alleged errors in application of Dr. Mellman's methodology. Complaint counsel make no claim that General Mills'

or General Foods' computations are not in accord with their respective methodologies or contain any errors.

742. In summary, each of the allocation procedures proposed in this case provides a rough approximation of how joint costs ought to [209]be assigned to the RTE segments of General Mills' and General Foods' overall businesses. And each is subject to the possibility of a degree of error. Each method falls within accepted accounting procedures and, in the absence of a showing that the methodology advocated by complaint counsel is superior for purposes of this case to those followed by General Mills and General Foods, the parties are entitled to rely upon the procedures most favorable to them. This is particularly true in the case of General Foods where the procedure has been followed in the normal course of its business.<sup>74</sup>

(b) Cash Flow Profile

743. A second critical element of Dr. Stauffer's formula is the cash flow profile. The formula relates the investment in plant, property and equipment to the associated cash flow generated by that investment. Cash flow equals the gross receipts that are associated with a product produced using the plant, property and equipment. From such receipts, costs such as labor, raw material, and supplies are subtracted. Thus, cash flow is the net money flowing in and does not include deductions for depreciation, research and development, or advertising which reflect outlays of cash for investment, not deductions from return on investment. Net income would equal cash flow minus these additional items and taxes (Tr. 19,354, 19,394, 37,499-500).

744. As previously explained (Findings 702-03), a rectangular cash flow profile assumes that the cash flow produced by an asset is the same for each year of the life of the asset; and a triangular cash flow profile assumes that the cash flow produced by an asset starts at a high level and declines steadily over the life of the asset. Inasmuch as cash flow data is not readily available, the profile of the flow had to be assumed. In the absence of actual knowledge, Dr. Stauffer applied his formula utilizing two alternative profile assumptions (rectangular and triangular) in order to establish lower and upper bounds of economic return.<sup>75</sup> Dr. Stauffer made no effort to

<sup>74</sup> Of course, it would be preferable to have General Mills' and General Foods' joint costs allocated by the same method, which is not the case, except for complaint counsel's cost method of allocation. But, inasmuch as the cost method may not be imposed, we are left with General Mills' and General Foods' joint costs being allocated by different methods.

<sup>75</sup> Kellogg's witness, Dr. Solomon, agreed that, in the absence of actual data, it is appropriate to work with two outside extreme assumptions with the further assumption that the correct answer lies somewhere in between (Tr. 31,216).

determine the true profile. The two profiles used were merely assumptions to establish bounds within [210] which the true profile would lie. Dr. Stauffer was of the opinion that in the real world, the result would lie somewhere between the rectangular and triangular extremes, but that he could not be more specific than that (Tr. 19,386-87, 19,395-97, 25,074).

745. The economic rate of return calculations may be affected significantly by the choice of cash flow profile (Tr. 19,394, 38,186). Each respondent has a substantially higher economic rate of return under Dr. Stauffer's formula when a triangular cash flow profile is used than when a rectangular cash flow profile is used (Tr. 38,051; CX 701Z-21, Z-22; GFX 1368).

746. Under circumstances where the rectangular cash flow profile or lower bound is a distinct possibility, I am precluded from applying against respondents any cash flow profile assumption which would result in the computation of higher economic rates of return. As detailed below, complaint counsel have failed to establish that the rectangular cash flow profile may not be a reasonable approximation of the cash flow experienced by respondents and others in the RTE cereal industry. Therefore, I shall not consider and apply against respondents any Stauffer type computation of economic rate of return which does not embody a rectangular cash flow profile.

747. Complaint counsel assert (CPF 11-84 thru 11-87; CRPF 11-103) that a declining cash flow profile "close to the triangular profile" or "closer to the triangular than the rectangular profile" is the appropriate cash flow profile to use in computing the RTE cereal companies' rates of return. This position, however, does not indicate just how close to the triangular the true profile is alleged to be. Complaint counsel ground their position on the general assumptions (1) that as assets age, the costs of maintenance increase and there are longer periods of downtimes, (2) as assets age, they tend to become obsolete as newer and more efficient equipment becomes available and older assets are placed on partial use or standby status, and (3) since a firm has a variety of assets with differing lifetimes, depiction of each asset by a box, with the shortest box on top followed by each longer box below with the longest box on the bottom, would result in a triangular diagram.

748. The cash flow profile varies from industry to industry and individual industry assessments are required to attribute specific profiles to particular industries. (Tr. 20,000, 20,029, 31,207-09, 31,215-21; CX 703A). Complaint counsel have made no such assessment for the RTE cereal industry, but rely primarily on the

testimony of Dr. Stauffer. Dr. Stauffer, however, had made no study of the cash flow in the RTE cereal industry and had no specific familiarity with the industry (Tr. 19,051, 19,993). In any event, Dr. Stauffer did not testify that the true profile would be "close" to the triangular profile, only that, in his opinion, the actual profile would be closer to the triangular rather than the rectangular profile (Tr. 19,592). And this opinion was based on his intuition, not on any study of the industry (Tr. 19,395, 19,592). Dr. Stauffer's intuitive expectations were based upon the same general considerations asserted by complaint counsel—that output would [211]decline as assets aged and became obsolete and that there would be increased maintenance costs (Tr. 19,395, 24,954–55).

749. However, there is no record evidence to support Dr. Stauffer's theory; and the record evidence tends to refute it.

750. The RTE cereal industry involves sufficiently complex processes that productivity increases over time and costs decrease due to the learning curve phenomenon. People learn to do their jobs better and engineering personnel find and remove bottlenecks (Tr. 24,963–65, 27,235–36, 27,289, 28,147, 31,252, 33,018–19, 36,664–70, 38,064–65, 38,483–84). For example, newer plants of Ralston had lower yields and greater production problems than older plants because of lesser personnel experience (Tr. 10,693, 10,723, 10,742–43, 10,755–56, 17,561); and Kellogg upped its production capability with respect to Product 19 by overcoming various production problems over time and because of the increase in efficiency over time of its personnel (Tr. 29,341–58, 29,364).

751. Maintenance costs for General Foods are highest during the start-up period of a new product manufacturing line. Thereafter, through an extensive preventive maintenance program, maintenance costs are lowered over the life of a project. The number of unscheduled break-downs are reduced and the durability of replacement parts is increased so that periods between planned maintenance shutdowns are lengthened (Tr. 36,677–87). Kellogg's equipment is also durable and requires little in the way of maintenance (Tr. 29,439). Its preventive maintenance program decreases the number of breakdowns and smooths out operations over time (Tr. 35,670–71, 35,685).

752. General Foods is often able to increase productivity and decrease unit production costs over the life of its assets. The components of a production process normally have differing capacities. By finding ways, usually with little or no additional investment, to increase the capacity of the limiting component, the capacity of the entire line can be increased. Production is also increased and

costs decreased through direct application of sophisticated engineering techniques (Tr. 36,665-70).

753. General Foods' production equipment is long lived. For example, ovens installed in 1927 to bake Grape-Nuts are still being used efficiently today, in part because of the regular upgrading of equipment that accompanies preventive maintenance (Tr. 36,686-87). Rather than finding that its older equipment was obsolete, General Foods found, in planning its Modesto facility, that duplicating its Battle Creek equipment would provide it with the most current technology (Tr. 36,690-91).

754. In any event, obsolescence is primarily a matter of longevity of assets, another aspect of Dr. Stauffer's formula. When an asset is retired because of obsolescence, this does not impact the cash flow during the life of the asset. [212]

755. To the extent that sales increase over time, cash flow would increase (Tr. 31,209). In an article in *Drug Development and Marketing*, published in 1973 or 1974, entitled "Profitability Measures in the Pharmaceutical Industry," Dr. Stauffer described the process of choosing an appropriate profile for use in computing the profitability of the pharmaceutical industry. Dr. Stauffer plotted the gross sales of successful pharmaceutical products and observed a product life-cycle profile with sales rising, then level and finally declining (Tr. 38,098-99).

756. It was Dr. Stauffer's opinion, expressed in this published work, that this product life cycle profile could produce an economic rate of return lower than that obtained by using a rectangular profile. Dr. Stauffer used a rectangular profile for his analysis of the pharmaceutical industry, explicitly recognizing that its use could overstate the economic rate of return (Tr. 19,990-91, 38,099).

757. Products accounting for over 50% of total RTE sales of General Foods and Kellogg enjoyed increased sales over time (Tr. 31,246-51, 38,101-04; GFX 1360). Productivity of equipment is increased as demand increases (Tr. 36,662-64). As in the pharmaceutical industry, this would indicate that the cash flow profile for the RTE cereal industry was at least rectangular, if not rising ramp, which would result in an even lower accounting rate of return (Tr. 31,246-47, 38,099, 38,105-08).

758. To the extent cash flow would have declined due to any rising costs, it is to be expected that respondents would have raised prices. Further, the extent of inflation over the period would have moved even a triangular cash flow profile toward the rectangular (Tr. 31,233-35, 38,482).

759. The purpose of Dr. Stauffer's formula is to correct the extent

to which the accounting rate of return overstates the economic rate of return (Tr. 19,360, 19,987). Yet, when a triangular cash flow profile is used in the formula with a rapid decay rate of advertising,<sup>76</sup> the result is an economic rate of return higher than the accounting rate of return (Tr. 38,081-83; GFX 1358). Further, with a triangular cash flow profile in Dr. Stauffer's formula, a firm would continue to invest heavily in advertising despite a negative cash flow over the last several years of the life of the investment (Tr. 34,782-87, 34,790-91, 34,864-65, 37,782-87, 38,092-97; GFX 1357; GMX 456). One would not expect a firm to continue to produce and heavily advertise an RTE cereal product for years while it continued to lose money.

760. As previously noted, complaint counsel contend (CPF 11-87) that, since the plotting on top of each other of blocks of varying [213] lengths depicting the different length of lives of different assets forms a declining triangular shape, the overall profile for the company must be triangular. This contention has no merit. What complaint counsel are arguing, contrary to the basic testimony of Dr. Stauffer, his original dissertation and his pharmaceutical study, and the testimony of all of the other experts who testified in this case, that there is no such thing as a rectangular cash flow profile. For every firm has assets of varying longevity and every firm's assets could be depicted in the triangular fashion relied upon by complaint counsel.

761. The manner in which Dr. Stauffer defines cash flow profile for use in his formula has nothing to do with the triangular depiction of different lived assets. If the individual underlying assets produce rectangular cash flows, it is immaterial how you stack one on top of the other by depicting boxes so that they come out in a triangular fashion. So long as the individual underlying assets produce rectangular cash flows, Dr. Stauffer's formula must use a rectangular cash flow profile (Tr. 35,146-47).

762. The overall economic rate of return for a firm is the result of the returns earned by each of its investments. If each investment (whether the same or of unequal life) earns at a rate of 5%, the company overall earns at a rate of 5%. If each investment earns its 5% through a rectangular cash flow, a rectangular cash flow profile is the appropriate profile to characterize the firm as a whole (Tr. 35,146-47).

763. To demonstrate this point, Dr. Troxel created a hypothetical firm with investments of different lives. Each was given a rectangu-

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<sup>76</sup> This relates to the advertising correction which will be considered below.

lar cash flow profile resulting in an economic rate of return of 10%. Thus, the company in total would show a 10% economic rate of return. The data on the firm were inserted into Dr. Stauffer's model using, alternatively, a rectangular and triangular cash flow assumption. Only the formula using the rectangular assumption produced the known correct answer of 10%. The formula using the triangular assumption computed a return of 12.3% (Tr. 35,127-49; GMX 463).

764. As Dr. Fox has explained, if a project has necessary components of differing lives, the entire process would stop and cash flow would fall to zero as soon as the shortest-lived asset gave out. The project would then have a rectangular profile with a service life equal to that of the shortest-lived asset. If, instead of allowing the project to die, the shorter-lived assets were replaced over the life of the longest-lived asset then, graphically, there would be a series of short boxes on top, a series of longer boxes on the next level and so forth; and the sum of the profiles would be rectangular (Tr. 38,075-77).

765. Complaint counsel, in their March 1976 trial brief and in their July 1976 revised trial brief, took the position that the appropriate cash flow profile in this case was rectangular (GFX 21, [214]22A-C). This obviously reflected the position at that time of complaint counsel's expert in the matter, Dr. Stauffer. At his April 1976 disposition, Dr. Stauffer took the same position. He said, "I decided early on to use a constant [rectangular] cash flow" instead of other profiles (Tr. 25,088-89, 25,231); that "there are sound reasons for using the rectangular profile" (Tr. 25,091). He explained that the "real" profile (CX 702D) was most likely to have a product life cycle shape, *i.e.*, one which rises gradually, plateaus and then declines gradually (Tr. 19,395-96, 25,114). He had run an "extensive series of simulations" and had found that the estimates using the product life cycle profile were "very close to the result obtained using a rectangular profile" (Tr. 25,095-98). He rejected the triangular profile. The assumption associated with a triangular cash flow profile that cash flow "rises rapidly" and then "dwindles away quickly" was not "empirically accurate" (Tr. 25,230-31). In estimating economic profits for the drug industry, Dr. Stauffer had used the rectangular profile assumption as a proxy for the "real product life cycle profile" (Tr. 19,988-90). He concluded that "the rectangular profile is, broadly speaking, appropriate" (Tr. 25,096). He also testified at the April 1976 deposition that his work in computing economic rates of return was completed (Tr. 25,227).

766. I read Dr. Stauffer's deposition testimony, given in April 1976, as unequivocally expressing his opinion that the rectangular

cash flow profile is the appropriate one for use in this case. Having read his testimony in hearings in October 1977, I fail to find any reasonable basis for accepting his later opinion in lieu of that previously given. Dr. Stauffer's original considered opinion as to the appropriateness of the rectangular cash flow profile is joined in by economic experts, Dr. Fox and Dr. Markham (Tr. 38,108, 38,482, 38,484).

767. While respondents have advanced arguments in support of using a rising ramp profile (KPF 5-112, 5-113, 5-128; GMPF 3-68; GPF 5-224), which would result in lower economic rates of return than by using the rectangular, respondents' uniform position is that a rectangular cash flow profile is appropriate (KPF 5-114, 5-127, 5-128; GPF 5-153, 5-160; GMPF 3-75, 3-76). On the basis of all of the evidence recited above, it is concluded that complaint counsel have failed to establish that any cash flow profile less favorable to respondents' position than a rectangular one may be utilized.

(c) The Advertising Adjustment

768. A third critical input into Dr. Stauffer's formula is the advertising decay rate. As previously explained, accountants treat all advertising as current expense even though it may benefit future years' incomes. To the extent that advertising generates sales in future years, an adjustment must be made in order to arrive at the true or economic rate of return. The rate at which past advertising continues to benefit sales is its persistence. Correspondingly, the [215]rate at which its benefit falls off is termed the decay rate.<sup>77</sup> Inasmuch as advertising expenditures are very high in the RTE cereal industry, the expensing of advertising substantially overstates the true or economic rate of return and the advertising adjustment is very important.

769. As part of his overall formula for computing economic rates of return, Dr. Stauffer incorporated what is known as the Koyck model to account for how the effects of advertising wear off over time (Tr. 19,415, 22,169-70).

770. The Koyck model assumes that the effects of advertising wear off at the same percentage rate each year. This percentage is known as the advertising decay rate (Tr. 19,416-18, 22,310-11; CX 702F). A decay rate of 80%, for example, means that if advertising generates \$100 of sales in year one, the sales generated by the original advertising will have worn off or decayed to \$20 in year two

<sup>77</sup> The decay rate can be viewed as a proxy for decay in the intangible asset, goodwill. Advertising is viewed as an investment in goodwill (Tr. 22,313).

and the sales will once again be 80% lower in year three than in year two, or \$4.

771. The Koyck model has been used extensively in the economic literature to represent the relationship between advertising and sales. Virtually all studies that have adjusted profitability to take account of the advertising bias have employed the Koyck model (Tr. 19,415, 22,170-71). Dr. Stauffer obviously used the Koyck model for lack of anything else, for his opinion of the model, previously stated in his pharmaceutical study and reaffirmed at this hearing, is as follows (Tr. 19,988-89, 24,989-90):

The assumed functional relation between sales and advertising, while plausible in its general features, is clearly *grossly oversimplified*, if not *arbitrary*, although it has been widely used in other economic analyses. That choice has been included *faute de mieux* in the detailed mathematical model described in the appendix with *no allusion as to its accuracy*. The contribution of advertising to the rate of return discrepancies for the [pharmaceutical] cases analyzed here is modest. So the overall conclusions are not affected by *the imprecision in the economic description of advertising*. It is useful to include even *this crude model* for sales response to advertising in order to better illustrate the direction of the necessary corrections, but it is important to note the caveat that in other applications *where advertising places a more [216]important role in the financial results, the estimates for the real rates of return might prove quite sensitive to the particular specification of the advertising sales response function* (emphasis supplied).<sup>78</sup>

Here, of course, advertising plays a most important role in the financial results.

772. While widely used in economic literature and studies, it is highly questionable whether the Koyck model provides a sufficient degree of precision to permit an adjudication of facts in a litigated matter where the proposed remedy is to require the respondents to divest themselves of assets and offer royalty-free trademark licenses of their remaining products. Nevertheless, since the Koyck model is an element in converting accounting rates of return into more accurate economic rates of return, I shall continue to consider Dr. Stauffer's conversion formula, including the Koyck model.

773. Because of the admitted imprecision of the Koyck model, however, which in large part flows from the difficulty in selecting an appropriate decay rate, I am compelled to accept the lowest rate (the one most favorable to respondents' position) which appears to be possibly correct.

774. While Dr. Stauffer used his own formula, which incorporated the Koyck model, he used alternative advertising decay rates of 35% and 80% which were estimated as lower and upper bounds by

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<sup>78</sup> Dr. Butters has described the Koyck model as extremely rough and imperfect (Tr. 37,636).

Dr. Schmalensee and Mr. Glassman (Tr. 19,420; CX 701Z-21-Z-25). Dr. Schmalensee had the primary responsibility to develop decay rates for purposes of presenting complaint counsel's case. Mr. Glassman relied upon the same data Dr. Schmalensee relied upon in reaching similar conclusions.

775. Dr. Schmalensee and Mr. Glassman relied in part upon several published economic studies for their estimates of the advertising decay rate for RTE cereals (Tr. 22,172-77, 26,135-38). Professors Parsons and Bass studied the effects of advertising on sales<sup>79</sup> (said by Dr. Schmalensee to be Kellogg's Corn Flakes and Sugar Frosted Flakes). Their analysis indicates that they believed the advertising decay rate for these brands to approximate 80% (Tr. 22,173, 26,135-36). Professor Darrel Clark, in an article which [217] surveyed more than 70 studies of the decay rate of advertising,<sup>80</sup> concluded that the decay rate for advertising is very rapid, approximately 90% per year (Tr. 22,176-77, 26,137-38, 37,787). Professor Ayanian estimated that the advertising decay rate for RTE cereals was 35%.<sup>81</sup>

776. Dr. Schmalensee testified (Tr. 22,176) that the Parsons and Bass study appeared to be a sound piece of work; that it used modern econometric figures with monthly data and, on the basis of methodology, was superior to the Ayanian paper. However, neither Dr. Schmalensee nor any other witness called by complaint counsel described the methodology used by any of the studies relied upon. No indication was given as to the supposed preciseness of the estimates.

777. The only witness who testified as to the methodology utilized in the studies relied upon by Dr. Schmalensee and Mr. Glassman was Dr. Butters. Dr. Butters testified that, whereas the Koyck model purports to utilize a decay rate on total sales, the literature relied upon by Dr. Schmalensee and Mr. Glassman does not reflect calculations of decay rates on total sales, but only on marginal sales (Tr. 37,652-54, 37,663-64).

778. The literature dealt with on-going products and thus was based on data involving relatively small changes in advertising from one period to the next, as opposed to data involving cessation or drastic reductions in advertising. Since the analyses included in the articles showed only the sales effect of small or "marginal" changes

<sup>79</sup> Frank M. Bass and Leonard J. Parsons, "Simultaneous-Equation Regression Analysis of Sales and Advertising," *Applied Economics*, 1969, pp. 103-24.

<sup>80</sup> Darrel Clark, "Econometric Measurement of the Duration of Advertising Effect on Sales," *Journal of Marketing Research*, November 1976, pp. 345-57.

<sup>81</sup> Robert Ayanian, "Advertising and Rates of Return," *Journal of Law and Economics*, October 1975, pp. 479-506.

in advertising, the decay rate literature analyzed only the impact on marginal sales (Tr. 37,642-43).

779. Since marginal sales (the increase in sales associated with a modest increase in advertising over a pre-existing level) would be, to a large degree, the result of "whim" purchases, rather than from the core of loyal users, such sales could be expected to decline more rapidly once advertising returned to its pre-existing level. It is more likely that marginal units of advertising would attract additional sales which, when the marginal units of advertising are withdrawn, would decay more rapidly than the rate for all sales (Tr. 37,647, 37,664).

780. The decay rate literature, which measures only the decay rate on marginal sales, is not useful for estimating a decay rate on total sales. A biased estimate results from this literature, because, for use in Dr. Stauffer's advertising term, it is not [218]measuring the right thing (Tr. 37,642-65). The measurement of the decay rate on marginal sales fails to measure the level of continuation of all sales if all advertising were stopped.

781. Complaint counsel assert (CRPF 11-147, 11-148) that the studies in question purported to measure the total decay rate on advertising, not marginal rates. Irrespective of what was purported to have been studied, Dr. Butters was the only witness who described what in fact was considered. And his testimony, which is unrebutted, clearly establishes that the studies were limited to analyses of marginal decay rates.

782. In addition to the economic articles on decay rates, Dr. Schmalensee and Mr. Glassman relied upon a study conducted by Dr. Schmalensee of RTE cereal brands which had had all advertising support withdrawn. Initially, Dr. Schmalensee calculated decay rates for seven products for which advertising was withdrawn and the products were subsequently withdrawn from the market prior to December 1972, the end of the time period he examined. Subsequently, Dr. Schmalensee added four products to his study for which advertising had been cut off, but which had not been withdrawn from the market as of December 1972 (Tr. 37,666-67; GFX 1329, 1330). Dr. Butters located and caused decay rates to be calculated for an additional five products which were still in national distribution as of December 1972 (Tr. 37,676-83; GFX 1329).

783. The mean decay rates expressed in percentages for the 16 products so selected are as follows:

Initial Decision

99 F.T.C.

Products in National Distribution	%	Products Withdrawn From Distribution	%
Puffa Puffa Rice	41	Puffed Corn Flakes	58
Concentrate	- 1	Corn Flakes w/Strawberries	38
Pep	6	Corn Flakes w/Blueberries	65
Krumbles	- 4	Bran & Prune Flakes	20
Grape Nuts Flakes	- 3	Clackers	76
Krispy Critters	8	(All) Stars	36
Treat Pak	- 2	OK's	31
Muffets	5		
Sugar Jets	42		

784. Two facts immediately stand out: (1) There is a tremendous variation in decay rates among products; and (2) Products which were withdrawn from national distribution prior to December 1972 generally had a much higher decay rate than those which remained in distribution after that date.

785. Among products remaining in national distribution, the variation in decay rates ranged from -2% to 42%; and for products withdrawn from distribution, the decay rates ranged from 23% to 76%. [219]

786. The negative decay rates for four of the products are plausible because market growth or a shift in consumer tastes can lead to increased sales even without advertising. Also, sales of some brands may be influenced by advertising for related brands. For example, sales of Grape Nuts Flakes may be affected by advertising for Grape Nuts (Tr. 37,685-86).

787. Brands differ in decay rates depending upon a number of factors, including the quality of the product. Other factors could include the length of time the product had been advertised, the amount of advertising of competing products, as well as institutional advertising or overall RTE cereal advertising by the company owning the brand in question. There is no single best way to arrive at a single number reflecting the various differing figures (Tr. 23,307-08, 26,574-77, 37,637-39).

788. The first seven brands selected by Dr. Schmalensee were withdrawn from the market by 1972. This indicates that they were failures in the marketplace and that their sales decay was not so much related to the withdrawal of advertising as to the fact they were failing brands. Also, a large part of the decay may have been due to a loss in distribution, not to a decision of consumers not to buy the product (Tr. 37,674-75). The other nine brands, while having greater consumer acceptance, as reflected by the fact they were not withdrawn from the market, were still not typically successful

brands. Otherwise, advertising support would not have been withdrawn (Tr. 37,676).

789. The large majority of advertising is associated with RTE cereals which have been successful and have been nationally advertised and consumed for 10, 20, or 30 or more years (GFX 1319). The 11 products studied by Dr. Schmalensee, by and large, had been nationally advertised for much shorter periods, but the decay rates were lower for those products which had been advertised over a longer period of time (Schmalensee, "Revised Estimates of Annual Advertising Decay Rates Based on Sales of RTE Cereal Brands with Advertising Withdrawn," Paper Presented for the FTC Bureau of Economics, April 1977, p. 4 (Table 2)) (GFX 1318; KX 25; CX-K 680C). So again, the products studied were not those typically associated with prolonged advertising. However, for brands on the market for a considerable period of time for which advertising support had been withdrawn, the decay rates were low, ranging from .005 to .14 (Tr. 23,310-11).

790. Of the nine brands which had greater consumer acceptance and less of a failing product bias, as reflected by the fact they were kept in national distribution, seven had advertising decay rates below 10%, and all but one rate were substantially below that figure.

791. The evidence, therefore, does not support Dr. Schmalensee's and Mr. Glassman's conclusions (Tr. 22,171-73, 22,177-79, 22,316-23, 26,136-38; GFX 1329, 1330) that the upper and lower bounds for the decay rate were 80% and 35%, respectively, and more likely to be closer to 80% than 35%. On the other hand, Dr. Butters' estimate (Tr. 37,687) that the decay rate could be as low as 10% is not [220] unreasonable in light of the studies made of individual RTE cereal products where advertising was discontinued, but the products remained in distribution beyond 1972. As explained above, I am required not to apply any decay rate higher than the lowest rate which appears to have a reasonable possibility of being correct.

### *3. Extent To Which Rates Of Return Have Been Established*

792. Applying Dr. Stauffer's formula and utilizing a rectangular profile and a 10% decay rate for each of the respondents, together with General Mills' and General Foods' methods of allocating joint accounting data to their RTE cereal business segments, the following economic rates of return are arrived at:

	Initial Decision			99 F.T.C.
	Kellogg	General Mills	General Foods	
1958-1970	11.7	10.5	7.3	
1954-1972	13.2	10.1	6.7	

(CX 701Z-22; GMX 466; GFX 1354)

793. I am not finding that the above figures constitute respondents' economic rates of return, but simply that there is a lack of proof of any higher figures.

794. Respondents assert that the rates of return are still overstated by reason of alleged omissions or errors in Dr. Stauffer's calculations.<sup>82</sup> The alleged errors are either not established or are offset by other aspects of the formula, and are minimal in nature particularly in comparison to the three major adjustments I have just ruled upon. The figures stated above, therefore, are sufficiently [221]accurate upon which to proceed in the appraisal of respondents' profits.

795. Quaker's accounting rate of return for the period 1958-1970 was 9% (CX 701A).<sup>83</sup> The purpose of Dr. Stauffer's formula is to adjust for those items which improperly are expensed, such as advertising and research and development, and to otherwise adjust for the time sequence of returns on investment in order to reduce the overstated accounting rates of return. As a company which was expanding with new products, Quaker obviously had large research and development and advertising costs which necessitated a downward adjustment. Indeed, Quaker's advertising to sales ratios were consistently higher than Kellogg's and were usually higher than General Mills' and General Foods' (CX 513). Nevertheless, applying Dr. Stauffer's formula with a rectangular cash flow profile and a 10% advertising decay rate, Quaker's 1958-1970 9% accounting rate of return did not go down but increased to a 12.4% economic rate of return. Normally, the higher the advertising decay rate, the higher the resultant economic return. In the case of Quaker, however, just the opposite result occurred. Using a 35% decay rate, its economic rate of return went down to 10%, and with an 80% decay rate, its economic rate of return went still lower to 8% (CX 701Z-22).

<sup>82</sup> All three respondents contend that Dr. Stauffer erred with respect to the timing of tax benefits connected with the expensing of advertising and research and development (KPF 5-102; GMPF 3-102; GF 5-334 thru 5-539). General Mills and General Foods assert that additional downward adjustments should have been made by reason of the quasi-capital nature of such items as promotion, market research and certain selling expenses, as well as product quality control, preventive maintenance and personnel training (GMPF 3-97 thru 3-101; GPPF 5-324 thru 5-533). General Foods asserts that Dr. Stauffer has underestimated the service life of its investments (GPPF 3-104, 3-105) and has incorrectly adjusted perceived differences between tax depreciation lifetimes and book depreciation lifetimes (GPPF 3-106, 3-107).

<sup>83</sup> Kellogg agrees (KPF 5-74) that Quaker has submitted all accounting data needed to calculate rates of return.

796. As discussed above, utilization of a triangular cash flow profile consistently results in a higher accounting rate of return than when a rectangular profile is used. In the case of Quaker, however, just the opposite occurred. Using a triangular cash flow profile, Quaker's economic rate of return was 10.2% at the 10% decay rate, .89% at the 35% decay rate and minus 34.4% at the 80% decay rate (CX 701Z-22).

797. It has been suggested that the unusual results with respect to Quaker flow from the fact that its rate of growth exceeded its rate of return (CPF 11-123; CRPF 11-249; Tr. 31,259, 38,089-90). Whatever the reason, it is clear that Dr. Stauffer's formula is inappropriate to measure Quaker's economic rate of return (Tr. 31,259, 38,089-92), and there is no record evidence of that rate. It may be assumed, however, that it was well below its 9% accounting rate of return.

798. Dr. Stauffer, on the basis of accounting data submitted by Ralston, made certain allocations and assumptions (Tr. 19,156-66, 19,670-76) and, using a rectangular cash flow profile and an advertising decay rate of 10%, arrived at an economic rate of return of 9.9% for 1958-1970 and 10.7% for 1954-1972 (CX 701Z-22).

799. The data submitted by Ralston differed from those supplied by the respondents and Quaker and were somewhat less comprehensive [222](Tr. 19,157). It was necessary, in order to approximate RTE cereal figures, to assume that the relationships between various accounting data for the RTE cereal segment were comparable to such data for the total Ralston corporation (Tr. 19,664, 25,175-80). In 1970, about 1½% of Ralston's total net sales were of RTE cereals (Complaint Counsel's Trial Brief, Vol. 1, ¶ 111.21). In light of the small portion of overall corporate endeavor accounted for by RTE cereals, the assumption could well be in error. The significance of any such error is conjectural. In any event, Ralston's rate of return is not substantially higher than the benchmark or normal rate of return contended for by complaint counsel.<sup>84</sup>

No calculations were made for Nabisco as no asset data were secured from that company.

#### 4. *The Benchmark Comparison*

800. Having determined the extent to which rates of return have been established for respondents and others in the industry, it becomes necessary to evaluate those rates to see if they are above

<sup>84</sup> This subject is considered next.

normal, or excessive. There are two definitions of a "normal" rate of return. They are consistent with each other. (1) Economists often define a normal rate of return as that rate which is necessary to attract appropriate capital into an industry (Tr. 21,706, 31,274-75, 31,356, 38,164). (2) A normal rate of return is also defined as one that is necessary to cover all costs of production and distribution including a "normal" or competitive return to capital invested (Tr. 21,692, 21,707, 27,991-92).

801. Rates of return significantly above a reasonable, competitive benchmark rate of return may indicate poor economic performance (Tr. 21,698-700, 21,719-22, 26,119-20). Complaint counsel rely upon the average rate of return earned by firms in the manufacturing sector of the United States economy as an estimate of the normal or competitive rate of return. The data relied upon to calculate this average rate of return for all manufacturing was compiled by the United States Internal Revenue Service ("IRS") in the "Statistics of Income"—the IRS annual summary volume covering income tax filings by all United States firms classified by the IRS in the manufacturing sector of the United States economy (Tr. 19,074-75).<sup>85</sup>

[223]

802. The average accounting rate of return on capital employed for all firms in the manufacturing sector was 8.9% (CX 701A). Using his formula, Dr. Stauffer converted the accounting rate of return to an economic rate (Tr. 19,683 *et seq.*, 19,720-21). There was no great problem of whether to use a rectangular cash flow profile or a triangular cash flow profile, or as to the appropriate advertising decay rate. This is because the benchmark figures overall do not include relatively large expenditures for research and development and advertising, the two principal bases for correction from an accounting to an economic rate of return (Tr. 25,099, 25,438-39). Therefore, there was not a very large correction to be made.<sup>86</sup>

803. Thus, for the period 1958-1970, the benchmark economic rate of return was 8.3% using a rectangular cash flow profile, irrespective of the decay rate. For the same period, the rate was 8.4% using a triangular cash flow profile, irrespective of the decay rate. For the period 1954-1972, using the rectangular cash flow profile, the rate of return was 8.2% with an 80% or 35% decay rate, and 8.1% with a 10% decay rate. And for this longer period, using a triangular cash flow profile, the rate of return was 8.4% with an 80% or 35% decay rate, and 8.3% with a 10% decay rate (CX 701Z-

<sup>85</sup> The IRS data set is the largest and most comprehensive source of such data available and has been used frequently by industrial organization economists studying industry performance (Tr. 19,079-80).

<sup>86</sup> Accounting data had already been corrected with respect to accelerated depreciation (Tr. 25,438).

21, Z-22). Inasmuch as I have used a rectangular profile and a 10% decay rate in reaching respondents' and Ralston's economic rates of return, I shall use the same assumptions for the benchmark. This gives us the following comparisons:

	<u>Kellogg</u>	<u>General Mills</u>	<u>General Foods</u>	<u>Ralston</u>	<u>Benchmark</u>
1958-1970	11.7	10.5	7.3	9.9	8.3
1954-1972	13.2	10.1	6.7	10.7	8.1

804. The respondents and Ralston are large, established firms which have shown profits over a number of years. The benchmark, on the other hand, reflects the activities of 200,000 manufacturing corporations, 40% of which have either no net income or negative income (Tr. 31,275, 31,334, 38,167-68). Based on 1970 figures, when firms which earned no income are excluded from the benchmark, the benchmark rate of return is increased by two points (Tr. 24,922-26, 31,345; GMX 78). Respondents' profits should not be evaluated on the basis of firms which had no income or negative income (Tr. 38,489-90). Therefore, a modification of the benchmark upward by two points is appropriate. This gives us the following: [224]

	<u>Kellogg</u>	<u>General Mills</u>	<u>General Foods</u>	<u>Ralston</u>	<u>Benchmark</u>
1958-1970	11.7	10.5	7.3	9.9	10.3
1954-1972	13.2	10.1	6.7	10.7	10.1

805. There are other biases in the benchmark which cannot be measured. For example, the sample is constantly changing. Many firms go bankrupt each year, while many are just starting up (Tr. 31,278, 38,165-66, 38,489-90). In 1954, there were 120,896 firms in the sample. In 1970, there were 197,807 (Tr. 38,165). New firms frequently have initial periods of very low rates of return or even losses until they get established. This biases the sample downward when it is being used in comparison with established companies whose start-up cost were incurred in the distant past (Tr. 38,166, 38,488-90). In Finding 804, I have adjusted the benchmark to exclude firms with no income. This still leaves firms with low rates of return attributable to their just starting up.

806. The large number of small firms in the IRS sample biases the benchmark average downward because the owners of such firms have a tax incentive to take the firms' profits in the form of high salaries. This results in an understatement of their profitability

relative to large, publicly-held corporations (Tr. 31,278-79, 38,166-67, 38,489-90). Some 80% of the IRS sample is composed of firms with total assets of under a half million dollars (Tr. 38,166-67).

807. When firms acquire others, they normally write up the assets acquired to reflect values at the time of acquisition (Tr. 18,314-15, 22,302, 24,914). Since the assets of the respondents have not been restated to reflect current values, the benchmark is understated to some extent in comparison with respondents.

808. On the other hand, the IRS data biases the benchmark upward to the extent it includes the return to those firms that are earning monopoly profits (Tr. 21,796, 21,798-99, 26,104, 27,990).<sup>87</sup>

There are two additional factors that must be considered before meaningful comparisons may be made between RTE cereal companies' rates of return and the benchmark. These are (1) inflation and (2) risk.

#### (a) Inflation

809. Dr. Stauffer made no adjustments for inflation, since he was not trying to compute absolute levels of profitability, but [225] rather to compare relative levels (Tr. 19,890-92). Thus, for both the RTE cereal companies and the benchmark, the fixed asset portions of capital investments were valued at cost at the times of purchase and were not adjusted upward to reflect current, inflated values (Tr. 18,314-15, 22,302, 35,887). Inflation, however, has a material effect on profit measurement. The issue is whether inflation has affected the individual RTE cereal firm computations and the IRS benchmark to the same degree (Tr. 19,891-92, 21,702, 21,707, 31,214, 31,231-34, 31,244, 31,254, 35,887-900, 38,482-84, 38,522-24).

810. The impact of inflation varies from firm to firm (Tr. 35,888-91, 35,896-900). Firms that have particularly old stocks of fixed assets will have their accounting statements affected by inflation to a relatively greater degree (Tr. 21,707). The bias on profits due to inflation is aggravated when computing the accounting rate of return by the expensing of quasi-capital expenditures, such as exploration, research and development and advertising (Tr. 25,126-27; KX 17, p. 13). The RTE cereal firms would appear to have older fixed assets than the average firm (CPF 12-62; Tr. 29,439). They engage in a considerable amount of research and development and clearly advertise much more than the average firm. Consequently, it must be concluded that the failure to account for inflation has

<sup>87</sup> However, Dr. Schmalensee, one of complaint counsel's economists, has testified that any such bias would be small (Tr. 21,799).

caused a greater upward bias on the computation of profits of the RTE cereal firms than on the benchmark.

(b) Risk

811. A higher than average return is still considered competitive or normal if the amount above the average is compensation for above-average risk. A normal rate of return for a business with above-average risk would be greater than for less risky businesses. And if an industry is risky, a potential entrant would require a higher than average return before it would consider entering (Tr. 21,706, 21,720-22, 23,233, 26,582-85, 38,486-87, 38,491-92, 38,517).

812. RTE cereal companies must introduce new products in order to remain profitable and compete for market share, and competition by introduction of new products has been intense (*supra*, Findings 530-31, 533).

813. As I have already found (Findings 652-53), after evaluating the high capital costs of entry, the long lead times required to recover capital investments, the costly and time consuming and often insurmountable problems of developing an acceptable product (with Procter and Gamble's experience cited as an example), the high failure rate of new products, and General Food's and Nabisco's drastic decline in market shares: [226]

... A potential entrant would not normally anticipate emulating the apparent success of the leading company, Kellogg, but would be forewarned of risks by the experience of other competitors. And General Foods' growth rate and experience would indicate a degree of risk and lack of attractiveness for new entry.

This observation of high risk would deter a potential entrant from entering the RTE cereal industry, unless it could foresee a rate of return higher than normal in order to compensate for the risk it would be incurring (citations omitted).

I then went on (Finding 664) to note the inability of Pillsbury, Colgate, International Multifoods, Carnation and H.J. Heinz to remain in the industry, a further indication of the risky nature of the industry.

814. Risk is further reflected by General Foods' drop in rates of return from 7.7% for the 1954-1970 period to a minus .1% for the period 1966-1970 (Tr. 38,125-26);<sup>88</sup> also by Nabisco's low, but highly variable, sales return on capital.<sup>89</sup>

<sup>88</sup> The rate of return was calculated with a rectangular profile and a decay rate of 10%, but used Dr. Mellman's allocations rather than those contended for by respondents.

<sup>89</sup>

Year	Percent
1962	1.9
1966	0.8

(Continued)

815. The benchmark derived from IRS data for the manufacturing sector cannot be deemed to draw an absolute line of demarcation between normal and monopoly profits. While such IRS data have generally been relied upon by economists, there is concededly some degree of inexactitude (Tr. 19,930, 25,534, 25,640, 25,646, 26,233; and note the various biases enumerated above). Further, the benchmark is simply an average of firms' earnings below the average and firms' earnings above the average. It cannot be said that every firm earning above average, whose rate of return contributed to reaching the average, is earning monopoly profits. Finally, while [227]not quantified, considerations of inflation and risk establish a normal rate of return for the RTE cereal respondents at a somewhat higher level than an average benchmark.

816. In consideration of the above, while the benchmark may be used as a rough guideline to aid in evaluating rates of return, a rate of return cannot be said to be monopolistic or supracompetitive unless it is substantially in excess of the benchmark. That is not the case here. General Foods' rate of return is substantially below the benchmark. Quaker's return may be assumed to be below it (Finding 796). General Mills' and Ralston's rates of return approximate it. Only Kellogg is shown to have a rate of return in excess of the benchmark; and, in consideration of the variables and biases discussed above, its rate cannot be said to be substantially in excess.

817. Even if Kellogg's rate of return were deemed to be substantially in excess of the benchmark, this would not evidence a violation under the complaint. The complaint alleges a shared monopoly and Kellogg would not be shown to have shared its allegedly monopolistic return with any other RTE cereal manufacturer. Kellogg was not charged with enjoying an individual monopoly nor could it with, at most, 44% of the market (*supra*, Finding 168).

818. Since the benchmark average is reached by combining a variety of rates of return which range above and below it, it is not suggestive of improper industry structure to find a distribution in the RTE cereal industry of one company (Kellogg) having a rate of return above the benchmark, two (General Mills and Ralston) with

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1967	.6
1968	4.9
1969	1.1
1970	1.4

rates of return approximating the benchmark, and two (General Foods and Quaker) with rates below the benchmark.

Again, I want to make it clear that I have made no findings of what respondents' and Ralston's economic rates of return have been. I have simply found those rates above which there is a lack of proof, and I have compared those rates with the benchmark.

#### 5. *General Foods' Profitability*

819. The record establishes that General Foods did not earn above-normal (supracompetitive) profits.

820. Complaint counsel (CPF 11-122), while contending that General Foods earned profits in excess of the competitive rate of return, recite that General Foods suffered poor management, committed costly errors in brand introductions and possessed an inferior production plant. More specifically, complaint counsel assert that General Foods had problems with its management and advertising agency due to a lack of continuity in personnel; that it had extraordinary failures in product development, losing over \$12 million alone on just three projects from 1966 to 1970; that General Foods recognized that its failures in new product development had "a [228]major negative effect on total cereal business profitability;" that it operated its plant at only 60% of capacity and had the least flexible, most dated and expensive to operate production facility of the major manufacturers.

821. Other matters, not recited by complaint counsel, include the following. General Foods, since at least 1952, considered that its RTE cereal profit margin was so low that it did not merit reinvestment in the business and did not provide sufficient contribution to overall corporate results (Tr. 36,369).

822. From 1952 to 1966, while the overall RTE cereal market grew 4% per year and the adjusted gross national product grew 3.6% per year, General Foods' RTE cereal annual growth was only 1.1% (GFX 1321). General Foods' market share over the period 1962 to 1970 declined from 19.7% to 14.0% (CX 106A, C). Its new product activities were overall costly failures (CX-GF 4039Z-17).

823. In light of its poor performance, General Foods organized a task force in November 1966 to study its RTE cereal business. One of the assignments of the task force was to decide whether General Foods should remain in the RTE cereal business (Tr. 23,617-19, 36,404; CX-GF 4039D-E). The task force recommended that General Foods remain in the business, in large part, because of large fixed costs already associated with its plant (CX-GF 4039E).

824. A second task force was organized in 1971 because management again was greatly concerned whether General Foods had the ability to compete (Tr. 13,884-85).

825. The 1967 task force reported that new cereals as a group had yet to show a profit, and the 1971 task force reported a \$13.1 million loss on new products since 1967 (Tr. 38,137-38; CX-GF 3000Z-167, 4039Z-5). In light of the importance of new products to effective competition in the RTE cereal market, this in itself reflects unsatisfactory profits.

826. It is hard to believe that General Foods, after some 70 years in the RTE cereal industry, would have considered getting out and absorbing the losses this would have entailed if it were earning a normal profit. A decision to close a business permits an inference that below-normal profits are being earned (Tr. 26,512-13). General Foods' consideration of quitting the RTE cereal industry allows a similar inference.

827. Complaint counsel (CPF 11-122; CRPF 11-238) would attribute General Foods' relatively low rates of return to poor management, costly major errors in brand introductions and inferior production plant. Without passing judgment on General Foods' management's expertise or on the wisdom or lack of wisdom in going forward with the new products that it developed (which I certainly am not qualified to do on the basis of this record), this would appear to reflect the risk facing a competitor in the RTE cereal industry. Further, to the extent General Foods' relatively low rate of return [229] can be explained away by poor management decisions and unsuccessful products, Kellogg's and General Mills' relatively higher rates of return may reflect superior management and superior products.

#### 6. *The COMPUSTAT Comparisons*

828. COMPUSTAT is an organization which provides financial data on some 1,000 corporations. The COMPUSTAT data tape is a computer tape which records the financial information of such corporations. The data is taken from several sources, primarily the firms' 10-K filings with the Securities and Exchange Commission (Tr. 19,163, 19,750-52, 19,755).

829. Dr. Stauffer computed an average economic rate of return for some 400 firms on the COMPUSTAT tape for which he had sufficient information, and arrived at a rate about .5% higher than the IRS benchmark (Tr. 19,758). The firms listed on COMPUSTAT are relatively large and successful (Tr. 24,771). They account for

approximately 75% of all the assets in the IRS Statistics of Income (Tr. 19,755).

830. Dr. Stauffer had considered using COMPUSTAT data to arrive at his benchmark. He did not, but utilized the IRS data as his only benchmark as he needed figures reflecting a larger and more representative sample of corporations (Tr. 24,755-58). The benchmark derived from IRS data, as modified above, is more reliable. In any event, the inflation and risk factors would still justify a higher rate of return for the RTE cereal industry than for the average COMPUSTAT rate.

831. Dr. Stauffer also did a dispersion analysis whereby he ranked firms covered by COMPUSTAT according to their profitability. Dr. Stauffer calculated economic rates of return for each of the firms in the COMPUSTAT data base for which there was sufficient data and then ranked the firms according to their rates of return. These included, for particular years, between 500 and 1,000 firms which are listed on the New York and American stock exchanges (Tr. 19,750-51, 19,755, 21,800; CX 701Z-23 thru Z-26). Dr. Stauffer prepared a graph covering the period 1958-1970 showing the percentage of COMPUSTAT reported companies that earned various economic rates of return (CX 701Z-23, Z-24, Z-25). Each cited exhibit shows the same graph for the COMPUSTAT companies. On each graph was plotted rates of return of the three respondents, Quaker and Ralston and a composite of those five cereal companies, under different cash flow profile and decay rate assumptions. The only exhibit to which further reference will be made is CX 701Z-25, as that purports to plot the economic returns of Kellogg, General Mills, Quaker, Ralston, and the composite of five cereal companies (the four mentioned plus General Foods) under a rectangular cash flow profile and a 10% decay rate.

832. Of all the companies plotted, only the entries for Kellogg and Ralston reflect what I have found to be the extent to which their rates of return have been established. Kellogg, with a rate of [230] return of 11.7%, falls among the top 16% of the most profitable firms in the manufacturing sector of the United States. Ralston, with a 9.9% rate of return, falls around the 30% mark. While Quaker is listed on the exhibit as being among the 12% most profitable companies with a 12.4% rate of return, I have already found that complaint counsel have failed to establish an economic rate of return for Quaker, but that Quaker's economic rate of return may be assumed to be well below 9% (Finding 797). Further, CX 701Z-25 uses the cash flow profile and decay rate which results in the highest rate calculation for Quaker among the various assumptions. General

Mills is plotted as having a 13% rate of return, whereas complaint counsel have failed to prove a rate any higher than 10.5%. This would place General Mills among the 23% most profitable companies rather than among the top 10% as depicted by complaint counsel. General Foods, whether at the 7.7% rate computed by complaint counsel or at the 7.3% limit I have found, has a rate of return so low that it is not depicted on the chart. The chart indicates that the 40% most profitable corporations have a rate of return of 9% or more. The composite of five cereal companies which shows a weighted return of 11.6%, which would place that figure within the returns earned by the 16% most profitable corporations, is in error since it is composed in part of overstated returns for General Mills and General Foods and a clearly overstated return for Quaker for which no return has been established.

833. Further, the significance of the dispersion of rates of return and the ranking of firms in profitability categories is weighted by the fact that a firm earning a rate of return equal to the IRS benchmark of a normal rate of return (10.3%) would be among the 26% most profitable corporations in the manufacturing sector. This is because the firms listed by COMPUSTAT are large and successful and account for 75% of all of the assets in the IRS Statistics of Income.

834. As stated in the prior section, "Impediments To New Entry In The RTE Cereal Industry," complaint counsel's theory of the existence of a barrier to entry into the RTE cereal industry is premised in part on the assertion that the industry has enjoyed supracompetitive profits. As I have found in this section, this premise fails for lack of proof.

### C. *Innovation As A Measure of Performance*

Complaint counsel assert (CPF 11-128, *et seq.*) that respondents have not been innovative in their efforts to bring new and better products to consumers; that their new product developments have been essentially variations of existing RTE cereal products rather than innovations; and that respondents resisted widespread vitamin fortification even though they believed it would provide consumers with new and better products. [231]

835. This last stated aspect of complaint counsel's assertion has already been found to be without substance. Respondents were innovative both in restoring their RTE cereals to whole-grain levels and in fortifying their products with vitamins and minerals (Findings 491-524).

836. Complaint counsel (CPF 11-129 thru 11-171) rely upon

evidence that tends to show the similarity of many RTE cereal products that were introduced to products already on the market. From this they argue that respondents have performed poorly in that they failed to be innovative in their introduction of products. Respondents, on the other hand (KPF 5-158, 5-159, 5-161 thru 5-163; GMPF 2-166 thru 2-169, 2-171, 2-175; GPPF 7-68 thru 7-139), rely on evidence which points up the differences between products and purports to establish the significance of those differences.<sup>90</sup>

837. Upon a review of the evidence, including many product formulas, it does appear that a number of RTE cereal products are quite similar without "earth shaking" differences. However, it also appears that complaint counsel are raising a question of the consumer welfare significance of new product introductions; and this is not a question for my judgment in this case. Any product that expands the choices of a consumer is an innovation. The significance of an innovation is determined by its success in the marketplace (Tr. 23,264-65, 23,391, 26,689-90). Whenever Kellogg introduced a product similar to that of a competitor, Kellogg believed that its product was superior (Tr. 29,805). During the complaint period, Kellogg nationally introduced 16 RTE cereal products, all but three of which were still on the market at the end of the period (Tr. 29,600-01; CX-K 1067, 7173; CX 434). By 1971, some 37% of all RTE cereal sales were of products introduced during the prior sixteen years (GMX 564).

838. I have already made findings relative to respondents' competition by the introduction of new products (Findings 530-602). Pertinent to the present issue are the findings that respondents have engaged in intense, unrestrained and uncoordinated competition in the introduction of new products; that each respondent attempted to seize every new product opportunity before its competitors, but, at the same time, tried to introduce similar products to compete with particular products of competitors; that each company was fully organized to recognize, evaluate and develop all perceived product opportunities.

839. The extent to which complaint counsel have been able to point out relatively insignificant product differences does not [232] evidence a failure to be significantly innovative. To the contrary, it demonstrates the extent to which respondents try to take advantage of every product opportunity. If respondents find it competitively expedient to beat their rivals to relatively insignificant product holes, it is all the more important that they vie for more significant

<sup>90</sup> Much of this evidence is in the nature of testimony of witnesses whose testimony I am required to accept at face value.

innovations. There is no evidence that they have not done so. And so we find that all respondents have competed by restoring and fortifying cereals with vitamins and minerals (*supra*, Findings 492-528); and that General Foods experimented with the inclusion of phosphates to inhibit dental caries (*supra*, Finding 511) and experienced costly failures in its efforts to develop and introduce cereals with freeze-dried fruits (*supra*, Finding 594).

840. There is no reason to believe that respondents have not attempted to come up with all reasonable innovations consistent with anticipated consumer acceptance.<sup>91</sup> Neither complaint counsel nor I are in a position to pass judgment on what, if any, additional significant innovations the industry could or should have come up with. It cannot be found that something more dramatic should have been developed, or that there are areas where innovativeness was neglected. The only area specifically alleged by complaint counsel to have been neglected is that of product fortification, and that allegation has been found to be unsubstantiated.

841. In addition to new product introductions, respondents have innovated production changes. Kellogg, for example, has improved its knowledge of how to work with grains over time and has continually made changes in product formulation, production and packaging which it considers to be improvements (Tr. 29,318, 29,790-91, 29,896, 29,974). It has been able to increase the running time capabilities of some of its product lines (Tr. 29,897-98). Certain products are made by different methods which are improvements over how they were made some years ago (Tr. 29,270-72, 29,278, 29,298-302).

842. General Mills spent over seven years in researching and developing the continuous puffing gun which replaced the batch gun. This increased product uniformity and eliminated problems that occurred with the start-up of each operating period. Each continuous puffing gun replaced six batch guns. Labor efficiency was increased fourfold. The shift-over resulted in less maintenance, a reduction of start-up times and a need for less floor space (Tr. 33,016-23, 33,127-30).

843. From 1961 to 1973, General Foods made 115 product changes on 17 of its trademarked brands. Eighteen were process improvements, 26 were formula changes designed to affect the nutritional value of [233]the products and 71 were other formula changes. Thirty-five of the 115 product changes were intended to lower costs without noticeably changing customers' acceptance of

<sup>91</sup> Procter and Gamble, after six years and up to \$1 million in expenditures, was unable to develop a product that it felt would receive consumer acceptance (*supra*, Finding 651).

products. In General Foods' current view, the purpose of the other 80 product changes was to improve the quality of the product (GFX 1370I).

*D. Wastefulness In Advertising Expenditures*

844. Since monopoly power is the ability to hold prices above competitive costs (Tr. 21,707, 26,100-05), the operation of businesses with excessive costs may manifest monopoly power and poor performance. Efficient firms will minimize their costs (Tr. 21,693, 27,655). Complaint counsel assert (CPF 11-185) that advertising cost levels in the RTE cereal industry are excessive and are imposed on consumers as a result of the existence of monopoly power. The following table shows advertising expenditures as a percentage of dollar sales for the years 1950 through 1972 for the six largest RTE cereal companies.

**SIX FIRM ADVERTISING-TO-SALES RATIOS**

	<u>Kellogg</u>	<u>General Mills</u>	<u>General Foods</u>	<u>Quaker</u>	<u>Nabisco</u>	<u>Ralston</u>
1950	.131	NA	NA	.166	.105	NA
1951	NA	.165	NA	NA	NA	NA
1952	NA	NA	NA	NA	NA	NA
1953	NA	NA	NA	NA	NA	NA
1954	.127	.175	.138	.186	.065	NA
1955	NA	.175	NA	NA	NA	NA
1956	NA	.176	NA	NA	NA	NA
1957	.124	.157	NA	.177	NA	NA
1958	.146	.185	.161	.218	.229	.211
1959	.172	.226	.159	.196	.173	.240
1960	.163	.174	.148	.207	.140	.296
1961	.153	.202	.135	.279	.152	.294
1962	.152	.184	.147	.256	.159	.288
1963	.152	.206	.153	.214	.192	.258
1964	.152	.202	.170	.202	.206	.232
1965	.166	.224	.186	.218	.218	.212
1966	.157	.198	.210	.202	.222	.218
1967	.156	.207	.221	.201	.174	.220
1968	.121	.173	.184	.210	.148	.162
1969	.121	.161	.154	.162	.105	.176
1970	.106	.132	.163	.164	.094	.185
1971	.097	.127	.147	.195	.112	NA
1972	.094	.148	.138	.131	.130	NA

NA - Not available.

(CX 513) [234]

845. This shows that the ratio of Kellogg's advertising-to-sales (A/S) ranges from over 9% in 1972 to over 17% in 1959. From 1950 to 1972, the Kellogg ratio exceeded 10% in 16 of the 18 years for which there is data. From 1951 through 1972, General Mills' A/S ratio exceeded 12% in each of the 20 years for which there is data. At its peak, in 1965, General Mills' A/S ratio exceeded 22%. From 1954 through 1973, General Foods' A/S ratio exceeded 13% in each of the 17 years for which there is data. General Foods' highest A/S ratio was reached in 1967 when it exceeded 22%.

846. The most information on advertising and sales for other industries exists for the years 1963 and 1967 (Tr. 27,676-78). The RTE cereal six company total advertising divided by the six company sales figure is .175 for 1963 and .172 for 1967.

847. A/S ratios for many manufacturing industries are reported in Stanley Ornstein's book, *Industrial Concentration and Advertising Intensity*, at pages 60-61 (1977). The mean A/S ratio calculated by Dr. Ornstein for 87 consumer goods industries was 3.8% in both 1963 and 1967, while the RTE cereal A/S ratio exceeded 17% in each of those years (Tr. 27,676-78).

848. The appendix to Dr. Ornstein's book separately reported A/S ratios for more than 320 manufacturing industries. Among the reported industries was Census Industry #2043, Cereal Preparations, which is somewhat more inclusive than the RTE cereal industry, but is the closest category to RTE cereal for the purpose of making an A/S ratio comparison. Cereals had the second highest A/S ratio of all manufacturing industries in both 1963 and 1967 (Tr. 27,677-78).

849. Of the A/S ratios of 42 industries listed by advertising economists William Comanor and Thomas Wilson,<sup>92</sup> only two were double-digit, one of which was of the RTE cereal industry.

850. Kellogg recognized that its advertising made it the most heavily advertised brand name on the American scene (CX-K 565K).

851. Respondents' high A/S ratio does not establish that their advertising has been wasteful. As previously found (Findings 425-443), respondents independently set levels of advertising for each individual product based upon their own judgments of required [235] advertising levels to reach or maintain projected sales levels. This record provides no basis upon which to substitute my judgment for that of respondents.

852. My feeling is comparable to that expressed by Dr. Schmalensee in *Brand Proliferation and Entry Deterrence: The Ready-To-Eat*

<sup>92</sup> Comanor, William S., and Wilson, Thomas A., *Advertising and Market Power*, (1974).

*Cereals Case*, Report, Bell Journal of Economics, February 1977, at p. 41, that it has not been established "that the existing level of advertising in RTE cereals is above the socially optimal level." Further, I do not believe it to be appropriate to mandate a "socially optimal level" of advertising in place of one reached as a result of competitive considerations. Our concept of a free competitive system does not envision imposition by government of permissible levels of advertising.

853. Advertising performs a necessary and legitimate function of advising prospective customers of the attributes of products offered for sale (Tr. 12,809, 22,475, 31,509, 26,665-67; CX-K 456; CX-GF 4039Z-94). Advertising may be used in lieu of alternative methods of promotion and its success may increase sales volumes and so reduce unit costs (Tr. 22,490-91, 28,557, 29,911). Advertising is particularly important in the RTE cereal industry where there are many nonhomogeneous products and competition is carried on in large measure by the introduction of new products.

854. The large number of nonhomogeneous products, each with its requirement for separate advertising, dictates a relatively high A/S ratio. This requirement is further impacted by the high incidence of new product introduction.

855. Introductory advertising is designed to inform people of the existence of the new product and its important attributes. Introductory advertising levels are usually higher than subsequent levels because, in order to best get a return on the product, the length of time spent penetrating the market must be as short as possible (Tr. 12,809, 31,509). Speed is desirable in order to establish a sales base quickly so that both the manufacturer and retailer can determine whether there is a good market for the product and enough people will buy it frequently enough for each to make money (Tr. 15,242). The advertising behind a product is important to the retailer because it shows whether the manufacturer believes in the item strongly enough to support it. Heavy advertising programs are required to help persuade retailers to stock new products (Tr. 9185, 29,911). Also, it may be necessary to increase the advertising on existing products to help combat the introduction of new products by others (*supra*, Findings 126, 545-46).

856. Complaint counsel themselves have contended (CRPF 8-283) that A/S ratio comparisons between respondents are not meaningful without adjustments for the introduction rate of new products. It follows that A/S ratio comparisons between the RTE cereal industry and other industries are also not meaningful without taking into account the heavy incidence of new product introduction in the RTE

[236]cereal industry. Not only is there the incidence of heavy advertising in connection with the sales of successful new RTE cereal products, but the heavy advertising of products that fail also increases the overall company A/S ratio. General Foods, for example, was concerned with wasted advertising expenditures on unsuccessful products (CX-GF 4039Z-22).

857. There are still other differences between industries which do not permit a meaningful comparison of A/S ratios. The nature of the product may differ to the point of justifying different levels of advertising expenditures, or electing between different methods of advertising (with different costs) or choosing between advertising and other forms of promotion (Tr. 22,464-67, 28,143-45). For example, advertising expenditures in the automobile industry exceed the level in RTE cereal, but the dollar volume of sales is so much greater that the advertising-sales ratio is lower (1972 Census of Manufacturers, Special Report, SR 2-6; SR 2-144).

858. Thus, a comparison of A/S ratios between industries, without more, does not allow an evaluation of whether the advertising in an industry is inefficient or is above an economic optimal level (Tr. 31,595).

859. Complaint counsel would substantiate their premise that respondents' high A/S ratios reflects advertising inefficiency and waste by reliance upon the Dorfman-Steiner principle.<sup>93</sup> The Dorfman-Steiner principle is composed of two parts. First, firms try to maximize their profits in choosing, among other things, the level of their advertising expenditures. Second, there are diminishing marginal returns to advertising, *i.e.*, as firms increase their advertising, the additional impact on sales decreases (Tr. 28,004-07). For example, an additional \$1,000 expended for advertising might cause the sale of an additional 5,000 units, but the next additional \$1,000 expended for advertising might cause the sale of only 2,000 more units. A point would be reached where the marginal return on the additional volume of sales would not equal the cost of the additional advertising that brought about those sales.

860. These two principles lead to the conclusion that the level of advertising is affected by the difference between selling price and marginal costs (the gross margin). The firm's profit-maximizing level of advertising will be higher when gross margins are higher, because the marginal returns to that advertising will be higher. Thus, the higher the price, all else including unit production costs being equal,

<sup>93</sup> Dorfman, Robert and Steiner, Peter, "Optimal Advertising and Optimal Quality," *The American Economic Review*, Dec. 1954.

the larger will be the expenditure on advertising (Tr. 28,004-12; CX 1008). [237]

861. The gross margin, or price-cost margin, is simply sales minus manufacturing costs divided by sales. More specifically, it is calculated as the value of shipments less payroll and materials costs divided by the value of shipments, *i.e.*:

$$\text{PCM} = \frac{\text{Value of shipments} - (\text{payroll costs} + \text{materials costs})}{\text{Value of shipments}}$$

(Tr. 27,698, 27,714).

862. Price-cost margins were calculated directly from the industry statistics contained in Table 1B of Volume 2 of the 1972 *Census of Manufacturers* and were verified later with accounting data supplied by Kellogg and General Foods. The *Census of Manufacturers* is published approximately every five years and is publicly available (Tr. 27,703-06).

863. The cereal industry is classified as Standard Industrial Classification Code (SIC) 2043 by the Bureau of Census. The industry classification includes hot cereal and some baby cereal. The Census data shows that the PCM for the cereal industry is 48%. This was the ninth highest price cost margin of 451 manufacturing industries (Tr. 27,719-20). The same tables of the 1967 *Census of Manufacturers* show that the cereal industry was tied for the sixth highest price-cost margin of the 412 industries reported (Tr. 27,720).

864. PCMs are not reliable measures of profitability, such as are the economic returns on capital employed, the measures actually relied upon by complaint counsel in this case.<sup>94</sup> PCMs, for example, do not take into account distribution and selling costs, capital intensity, research and development, risk and various timing factors. In the absence of proof that any firms in the RTE cereal industry were enjoying supracompetitive economic returns, and the established fact that General Foods and Quaker were not, it cannot be held that any RTE cereal advertising was caused by monopoly profits. [238]

865. The Dorfman-Steiner principle is just that—a principle or theory of how gross margins will be expended on additional advertising. It does not take into account the extent to which

<sup>94</sup> Complaint counsel, in a section dealing with price competition (CPF 8-14) assert that the RTE cereal industry is extremely profitable as shown by its price-cost margins. This is an isolated reference and the contention is not developed or even referred to in the sections of their brief dealing with the issue of excess profits (CPF 11-18 thru 11-127). PCMs constitute an incomplete view of corporate activity and are not reliable indicators of the state of competition in an industry (Tr. 26,100, 31,581).

advertising expenditures will be dictated by competitive requirements.<sup>95</sup> And, as previously found, competitive requirements in the RTE cereal industry necessitate high advertising expenditures. The Dorfman-Steiner principle would not apply to the advertising of products which turn out to be failures; and it may well be that the costs of introductory advertising together with those of introductory promotions could exceed the gross return on new products for some time, so that there is no price-cost margin to consider expending for additional advertising.

866. Thus, the Dorfman-Steiner principle cannot be applied with the surety that advertising levels are coordinated with PCMs. This is apparent from an examination of the A/S ratios and gross margins of firms in the RTE cereal industry. Here, we find that General Mills has a higher gross margin than Quaker. Yet, Quaker's A/S ratios are consistently equal to or higher than those of General Mills. Kellogg's and General Foods' gross margins are close, but General Foods has much higher A/S ratios:

**COMPARISON OF GROSS MARGINS (GM)  
AND ADVERTISING-SALES (A/S) RATIOS  
1966-70**

	Kellogg		General Mills		General Foods		Quaker	
	GM	A/S	GM	A/S	GM	A/S	GM	A/S
1966	.36	.16	.44	.20	.36	.21	.39	.20
1967	.36	.16	.44	.20	.37	.22	.42	.20
1968	.36	.12	.45	.17	.39	.18	.40	.21
1969	.36	.12	.47	.16	.39	.15	.40	.16
1970	.36	.11	.49	.13	.39	.16	.41	.16
1966-70	.36	.13	.46	.17	.38	.19	.40	.19

(Source: GMX 239, 553A).

867. Complaint counsel (CPF 11-200) assert that the pricing and advertising of Kellogg's Corn Flakes in the late 1960's and early 1970's evidences that the Dorfman-Steiner principle has operated in [239]the RTE cereal industry. Sales of Kellogg's Corn Flakes were going down coincident with Ralston's private label price competition. Kellogg maintained its list prices through 1970. It reduced advertising expenditures between 1966 and 1972, as well as its A/S ratio, but granted case allowances in 1968, 1969, and 1970 and reduced list

<sup>95</sup> For example, firms increase the advertising on particular products in anticipation of the introduction of competitive products (Tr. 22,133-34).

prices in 1971 (Tr. 17,528, 28,014-16; CX-K 856, 868, 1072, 7073B, 7083B, 7192G-H; GFX 1318, 1319).

868. It cannot be said to what extent the pre-1966 advertising levels reflected advertising requirements or, if at all, an application of the Dorfman-Steiner principle. The same may be said of Kellogg's actions taken after 1965.

869. The Corn Flakes situation is an isolated instance which may reflect a myriad of business considerations and cannot be relied upon to characterize respondents' advertising practices overall. Their practices overall are more properly evidenced by the comparison of gross margins and A/S ratios which has been considered above. In any event, advertising is engaged in to produce sales and profits, and there is nothing amiss for a manufacturer to increase advertising to the point of realizing all marginal returns possible. In the absence of a showing that respondents were earning supracompetitive profits, their advertising levels, even to the extent they may be based on marginal returns, cannot be termed inefficient or wasteful.

870. In summary, I start with the basic assumption that advertising is a viable and legitimate method of competition. And complaint counsel have failed to demonstrate that the large volume of advertising in the RTE cereal industry does not have a competitive basis or that it reflects the existence of supracompetitive profits. A firm advertises in order to generate or increase sales and so increase profits. At the same time, once profits are realized, or in anticipation of profits, the firm may increase advertising up to the point of realizing all possible marginal returns. This, however, is pure theory and no findings can be made as to the extent respondents have increased normally competitive advertising levels to take advantage of the Dorfman-Steiner principle.

871. While the Dorfman-Steiner principle is logically sound, there is still another basic principle; and that is that, at a lower price, there may be a greater potential to sell more products, so that a firm with lower prices may increase its advertising to reach its potential (Tr. 31,590, 31,595).

Complaint counsel (CPF 11-205 thru 11-208) assert that respondents have engaged in wasteful advertising by misdirecting consumers to products which do not have the attributes or advantages over other products claimed in their advertising. Complaint counsel have abandoned their claims that respondents' advertising was false and misleading (Tr. 29,073; Complaint Counsel's Answer To Respondents' Motions To Dismiss, February 24, 1978, at A-14, A-15), and the issue cannot be resurrected at this time. [240]

### E. Waste and Misallocation of Resources

In the introductory portion to their section on performance (CPF 11-12), complaint counsel explain an aspect of consumer loss when an industry prices above cost. "This is due to the law of demand—the higher the price, the lower the quantity demanded of a good. Whenever an industry prices above the competitive level, consumers demand less than they normally would, output is restricted, and thus, resources which should have been devoted to production of the good will be diverted to other goods and a misallocation of resources results . . ." (Tr. citations omitted). Complaint counsel then quote from economist, Clair Wilcox (C. Wilcox, *Public Policies Toward Business*, 11 (1955)), in part, as follows:

The mobility characteristic of competition thus tends to achieve the allocation of resources that consumers desire. Monopoly, by contrast, frustrates such an allocation. The monopolist is likely to increase his profit by raising his price. *He will then limit his output to the quantity that the market will take at the price that he has fixed.* Consumers who would be willing to purchase larger quantities of his product at a lower price are left, instead, to buy goods that are wanted less. Resources are thus diverted from those things which the community prefer to those which are, at best, a second choice (emphasis supplied).

Complaint counsel then conclude (CPF 11-13):

The loss that results when resources are misallocated is called the "deadweight" or "welfare" loss . . . (Scherer, Tr. 27,999-28,000). "It is a loss of value that the consumers would have realized if they could have consumed at prices equal to cost. So consumers lose it. *It is an inefficiency that comes from the restriction of output by monopolists causing consumers willing to pay a price greater than the cost not to be able to make those purchases*" (Scherer, Tr. 28,000) (emphasis supplied).

872. While this aspect of the economic law of supply and demand is stated in general terms, complaint counsel obviously intend it to be descriptive of the RTE cereal industry. Complaint counsel, however, have failed to show how the law of supply and demand has [241]impacted the cereal industry or its customers. The record does not support complaint counsel's assumption that there have been high prices in the RTE cereal industry to the extent that demand has been impacted and producers have curtailed supply.

873. The cereal industry has experienced rapid and substantial growth, indeed substantially faster than the growth of all goods and services and faster than the growth in real output of the economy as a whole (*supra*, Findings 162-66). RTE cereal prices have been maintained at a level substantially lower than those of most other breakfast foods (*supra*, Findings 49-50), and price differentials in favor of hot cereals have not impacted the sales of RTE cereals

(*supra*, Finding 50). The RTE cereal industry is less price sensitive than other commodity industries (Tr. 23,113, 27,134), and the cost of RTE cereals is not a very important component of the total food budget (Tr. 27,142).

874. Consumers are being offered a large number of RTE cereal products at various prices from which to choose. At the lower edge of the pricing spectrum, we find the leading RTE cereal product, corn flakes. Consumers who may be interested in the lowest available prices may choose from Kellogg's Corn Flakes, General Foods' Post Toasties, General Mills' Country Corn Flakes and private label corn flakes (*supra*, Finding 72; Tr. 16,611, 17,750, 25,815-16, 28,821). The presence of private labels in this segment would mean the availability of prices even lower than those of the branded products.

875. There is no showing that any consumers are being priced out of the market. And, as Dr. Scherer testified, if buyers are able to purchase a product at a price they are willing to pay, even though the price exceeds the manufacturer's costs, allocative efficiency is being satisfied (Tr. 27,652).

876. On the other side of the coin, there is no evidence that respondents have limited supply. Each company has attempted to come up with new products to replace volume attrition of existing brands and to increase its market share (*supra*, Findings 533-40). While General Foods was relatively unsuccessful in its efforts, both Kellogg and General Mills have maintained their operations at a high level of capacity (*supra*, Finding 407; Tr. 26,726).

877. Economist Michael Glassman, introduced by complaint counsel, has suggested that Kellogg, for example, could sell more if it were to lower its prices (Tr. 26,569), and that it could meet that increased demand by building more capacity (Tr. 26,726). This suggestion is rejected. Kellogg has the right to exercise its own judgment with respect to operating under current production capacity. Kellogg, which enjoys some 40% of the market, may well believe that it is already supplying all of its cereals that the consuming public wants, and that it would not be economically feasible to make additional capital investments. [242]

878. In summary, there is no showing that consumers have reduced their overall consumption of RTE cereals because of alleged supracompetitive prices; nor is there any showing or reason to believe that, if prices were lowered, demand or supply would be increased.<sup>96</sup>

<sup>96</sup> I am not finding that the RTE cereal industry is immune to the impact of the economic law of supply and demand; simply that there has been no showing that extant prices are so high as to have reduced demand or supply.

### F. Consumer Overcharge Calculation

Complaint counsel (CPF 11-209 thru 11-232) utilize several alternative methods to calculate the amounts by which consumers have been overcharged by reason of respondents' alleged supracompetitive profits. Having found a lack of proof of supracompetitive profits, there are no overcharges to calculate. Nevertheless, some of complaint counsel's methods of computing the asserted overcharges merit comment. Complaint counsel recite (CPF 11-212):

In July 1971, Kellogg reduced the list price of its Corn Flakes by 16%, from \$6.90 for a case of 24 12-ounce boxes to \$5.80 for a case of 24 12-ounce boxes (CX-K 7192G, 7083B, 7073B; Scherer, Tr. 28,015). In order to "still show an impressive price spread" between Ralston's private label Corn Flakes and Kellogg's Corn Flakes, Ralston reduced its prices from \$5.80 a case to \$5.50 (CX-R 1516A).

From this, complaint counsel argue (CPF 11-213) that the price of Kellogg's Corn Flakes had been inflated by at least 16% due to monopoly power; and that it is likely that all RTE cereal prices have been inflated by a comparable amount. Complaint counsel (CPF 11-214) then take 16% of the total sales of branded products and arrive at a \$1,037,980,000 overcharge for the three respondents for the years 1958-1972 and a \$1,223,135,000 overcharge for the respondents and Quaker, Ralston, and Nabisco for that period. The figures include a \$207,817,000 overcharge attributed to General Foods even though, as found above (Findings 819-26), General Foods did not earn supracompetitive profits.

879. Kellogg's 16% price reduction on a single product in the year 1971 cannot be interpreted as a reflection of 16% monopoly profits on that product. It certainly cannot be interpreted to mean [243]that Kellogg was earning 16% monopoly profits on all products from 1958 through 1972; and most certainly it cannot be interpreted to mean that the five other largest firms in the industry were earning 16% monopoly profits on all of their branded items.

880. Complaint counsel next (CPF 11-215 thru 11-221) would apply the 3.8% advertising to sales ratio found by economist Stanley Ornstein for 87 consumer goods industries (see *supra*, Finding 847) to the RTE cereal industry, and conclude that all advertising in excess of the figure was wasteful. Having already found (*supra*, Findings 847-77) that it would be inappropriate to compare the RTE cereal industry's A/S ratio with the 3.8% figure and that there is a lack of proof that advertising in the RTE cereal industry is wasteful, complaint counsel's calculations are meaningless.

881. Finally, complaint counsel's attempts (CPF 11-222 thru 11-230) to calculate the extent of alleged supranormal profits on the

basis of its already rejected accounting and economic rates of return in relationship to a benchmark are similarly rejected. [244]

#### SUMMARY AND FURTHER DISCUSSION

Complaint counsel advance two grounds for asserting that respondents have violated Section 5 of the Federal Trade Commission Act: (1) Conspiracy; and (2) Acts and practices of respondents and economic performance of respondents and the RTE cereal industry, under a shared monopoly industry structure.

The complaint as issued failed to charge a conspiracy and was never amended to encompass that charge. While the ALJ before whom the case was then being heard allowed complaint counsel to proceed under a conspiracy theory, respondents never consented to this. The issue of conspiracy, therefore, may not be deemed to have been raised under the concept of conformance to the evidence under Section 315(a)(2) of the Commission's Rules of Practice, which requires that the issue be within the scope of the complaint and be tried with the consent of the parties. Respondents, therefore, may not be found to have violated Section 5 by reason of conspiracy.

Notwithstanding this holding, in consideration of the fact that this case was allowed to be tried under a conspiracy theory and in light of the unusually long time it has taken to try this case and the voluminous record that has been compiled, I have made all findings called for by the evidence, including those relating to the issue of conspiracy.

In any event, complaint counsel's case fails under either of its theories for lack of proof.

The factual issues, to a large extent, are common to both the conspiracy and the "shared monopoly" theories. Under the conspiracy theory, it was necessary for complaint counsel to establish that the respondents acted in particular noncompetitive fashion pursuant to agreement, express or tacit. Under the "shared monopoly" theory, many of the same acts and practices are asserted to be demonstrative, and an exercise, of respondents' alleged monopoly power.

While the oligopolistic structure of the RTE cereal industry is an essential element of complaint counsel's "shared monopoly" theory, respondents are not charged with violating Section 5 simply on account of the structure of the industry. Complaint counsel recognize that in an oligopolistic industry the members may be competitive or they may operate together in a monopolistic manner, so that, in addition to the structure of the industry, "a careful analysis . . . of

the conduct and performance of the sellers must be undertaken (CPF 6-17).

Complaint counsel assert that respondents avoided price and nonprice competition on RTE cereal products. Complaint counsel assert that each respondent is aware that it is to their mutual advantage to avoid competitive activities which can only bring about responsive competitive activities by their large rivals. The firms, therefore, avoid such competitive acts in accordance with understood rules of the game. [245]

On the issue of the avoidance of price competition, and in support of their structural approach, complaint counsel rely upon a generally accepted economic theory of Dr. Jesse W. Markham. That theory is to the effect that, in industries having certain characteristics, one would expect price leadership in lieu of overt collusion. One of the conditions required under Dr. Markham's theory, is that the commodity produced by the several firms be viewed by all of the firms as extremely close substitutes for each other. This condition is not met in the RTE cereal industry. To the contrary, there are many different types and categories of RTE cereals.<sup>97</sup>

"Price leadership" among clearly differentiated products is meaningless. It is necessary to have products sufficiently similar so that price is a primary element and can be coordinated by following a price leader. In this industry with differentiated products, it is not clear what there is to be coordinated. Price cannot be identified and isolated for particular products as something the sellers can focus on for purposes of coordination.

The RTE cereal industry, therefore, has not been shown as one in which price leadership in lieu of overt agreement is to be anticipated. Respondents' unlimited product competition with non-homogeneous products is inconsistent with a desire or effort to coordinate their activities and eliminate competition. To the extent they have proliferated products, they have engaged in a manner of competition that hinders and restrains coordination.

The record evidence pertaining to respondents' alleged price coordination is what might be expected from the above analysis of Dr. Markham's economic theory. A pricing pattern consistent with coordination was established with respect to only three sets of products—Kellogg's Corn Flakes and General Foods' Post Toasties; Kellogg's and General Foods' Raisin Brans; and Kellogg's Sugar Frosted Flakes and General Foods' Sugar Coated Corn Flakes. Other than for these three sets of similar products, there is no evidence of

<sup>97</sup> Another condition not established on this record is that individual firm cost curves must be sufficiently similar so that some particular price allows all firms to operate at a satisfactory rate of output.

price uniformity, maintenance of pricing levels, or pricing responses consistent with a pricing agreement or arrangement among respondents or with price leadership and followership.<sup>98</sup> For all [246]other products, the record tends to evidence a lack of brand price coordination or parallel pricing movement.

The evidence complaint counsel rely on to show a pattern of price leadership in lieu of overt collusion, with Kellogg being the price leader, consists of an analysis of pricing rounds in the industry covering 1965 through 1970, prepared and testified to by Dr. Scherer. As described by complaint counsel, "A price round is a series [or group] of list price changes that occur when a firm changes the price of two or more regular size branded products" (CPF 8-83). The lack of probative value of this analysis has been found as follows:

Finding 265. The 16 price rounds, as presented by Dr. Scherer and relied upon by complaint counsel, do not take prices into account other than for the fact that price changes were made. Levels and magnitudes of price changes are ignored. Indeed, the price round presentation does not even demonstrate that "lead" price changes on particular products were followed by price changes on what may be termed directly competing products. To the contrary, the amount of price change varied by product, and the types of cereals involved in one company's price change varied from those in the subsequent price change of other companies. In short, there is no correlation of individual products or individual product prices in Dr. Scherer's price rounds. Indeed, individual products and prices are not even evaluated. There is, therefore, no showing of correlation of any brand prices or price differentials as to particular brands.

Dr. Scherer has conceded that, for most products, "there seems to be very little pattern in the relationships between changes in the price of one product relative to changes in the price of another" (Tr. 27,922).

In addition to the failure of the price rounds analysis to contain necessary product and pricing information, the rounds are inconsistent with price leadership-price followership. Kellogg, the alleged price leader, was not always first in announcing price [247]changes; and price changes by one respondent were not always followed by the others. Also, when a price change was followed, it was often only after a long delay.

Kellogg set prices for RTE cereals on the basis of a guideline for gross margins and a target net profit figure. It did not establish prices in order to maintain a profitable price structure for its RTE cereal competitors. The record reflects genuine, independent business reasons why General Mills and General Foods did not originate

<sup>98</sup> Economists expect price similarity, even identity, for very similar products under competitive conditions. Price uniformity alone is insufficient to establish a price fixing conspiracy, since this may be the normal result of competition among similar products. See, e.g., *Morton Salt Co. v. United States*, 235 F.2d 573 (10th Cir. 1956); *FTC v. Lukens Steel Co.*, 454 F.Supp. 1182, 1190 (D.D.C. 1978).

price changes more frequently than they did and why they followed price increases of their competitors to the extent that they did.

Having failed to establish coordination on the part of respondents relative to the establishment, maintenance or change of prices for RTE cereals, complaint counsel have failed to prove (1) a price fixing conspiracy, or (2) noncompetitive pricing activity under a shared monopoly theory.

Complaint counsel assert that respondents have supported their pricing arrangement by refraining from indirect forms of price competition which might have spiraled into unrestrained price competition. These include trade deals, the use of cents-off labels, the insertion of in-pack premiums, and the production of private label cereals. Complaint counsel also assert that, while respondents offered discount coupons, their use was insignificant.

However, complaint counsel have failed to establish that respondents, either by agreement or by means of price leadership-price followership, fixed or coordinated list prices. There is, therefore, no price fixing arrangement shown, to be supported by refraining from indirect forms of price competition. In any event, the record fails to establish that respondents' activities with regard to indirect pricing activities were as a result of agreement or arrangement or flowed from the structural nature of the market. To the contrary, the record shows that, to the extent respondents acted similarly, each respondent reacted individually to common market conditions and the advent of television as a marketing device.

In addition to individual reactions to common marketing and advertising factors, respondents made independent decisions on the basis of their own situations. General Foods, for example, went through a period when it stressed a full line promotional approach. General Foods, accordingly, cut down on individual item promotions (including trade deals, cents-off labels and in-pack premiums). On the matter of production of private label products, neither General Mills nor Kellogg had the degree of excess capacity over an extended period of time that was required to enter into long term commitments to provide private label products. General Foods, on the other hand, had produced private label RTE cereal products since at least 1937 and attempted to expand its private label business. It discontinued private label only after it had suffered financial reverses and was unable to generate appropriate returns. Contrary to complaint [248]counsel's attempt to downplay respondent's utilization of coupons, couponing was widely used by respondents and they were redeemed by consumers at significant levels.

Complaint counsel have failed to establish that respondents'

indirect pricing activities were in accordance with any agreement, tacit or otherwise, or that respondents' activities reflected anything other than independent business decisions made in an effort to further legitimate business interests.

Complaint counsel assert that respondents avoided acts of non-price competition that might have led to price competition or that potentially might have threatened their goals of maintaining marketplace stability and maximizing profits.

Respondents exchanged advertising data through the A. C. Nielsen Co. Complaint counsel assert that this exchange of advertising information allowed respondents to prevent an expensive advertising war. However, there is no evidence that the respondents utilized the information to curtail or otherwise coordinate their advertising efforts. To the contrary, the record shows that industry members competed very strongly against each other in their advertising endeavors. Respondents' advertising expenditures followed markedly different and varying patterns both overall and on individual brands.

The complaint charged respondents with having maintained and utilized monopoly power. The exchange of advertising data was not alleged as a violation of law. Therefore, the failure to show that such an exchange was utilized for monopolistic purposes constitutes a failure of proof under the instant complaint.

Complaint counsel assert that respondents had a tacit agreement to avoid competition for shelf space in retail stores; that Kellogg formulated and implemented a shelf space allocation plan and General Mills and General Foods acquiesced in that plan. The assertion has no record basis.

Kellogg's shelving program advocated space according to sales and grouping by manufacturers. The program was unilaterally instituted by Kellogg to afford it a competitive advantage over other RTE cereal manufacturers, including the other respondents. There is no reason to believe that General Mills or General Foods was party to the institution or implementation of Kellogg's plan.

Retailers adopted Kellogg's recommendations because such recommendations served their own profitability and efficiency interests and were considered the most reasonable way of stocking RTE cereals.

Faced with Kellogg's shelving program which advocated space according to sales and grouping by manufacturers, which principles were logical and advantageous to retailers, as well as ones to which retailers were accustomed, it is not surprising that General Mills

and General Foods advocated the same guidelines when they competed for shelf space. [249]

While all three respondents generally advocated shelving by manufacturer and allocation of space according to volume, they each competed for all the space it could get. This included efforts to get more than a "fair share" of shelf space if its credibility would not be impaired by doing so. And each recommended the discontinuance of slow moving products of its competitors.

General Foods developed "Compact Packages" which were resized versions of existing cereal packages, designed to hold equivalent quantities of cereal in smaller boxes. General Foods thought this would enable it to acquire facings for additional items and would also add to its prestige as a leader in innovative shelving and so secure greater acceptance for its shelving recommendations. The program was a failure and General Foods lost shelf space as a result.

In 1971, General Foods developed and introduced C.O.M.P.A.S.S. (Customer Oriented Method of Profitability and Sales Service), a computerized system for making shelf space allocation recommendations on the basis of product profitability. However, retailers were not interested in the program.

Finding 490 summarizes the situation with respect to shelf space competition as follows:

It is concluded, therefore, that the record does not support complaint counsel's assertion that respondents had a tacit agreement to avoid competition for shelf space in retail stores. Kellogg independently formulated a shelf space allocation plan that incorporated principles which were in accord with retailers' preferred methods of doing business. The other respondents, faced with the same requirements of retailers, responded with plans that incorporated the same basic principles. While each respondent competed for the most favorable shelf space location and the most space it could get, it was constrained not to push for more than a reasonable share in order to maintain rapport and credibility with retailers. Nevertheless, both General Mills and General Foods did present shelving alternatives and variations in an effort to gain competitive advantages.

Complaint counsel assert that respondents avoided widespread product fortification until outside pressure forced them to fortify their cereals; that fortification then occurred as a result of coordinated activity to ensure that no one of the respondents would gain a competitive advantage by introducing fortified products before the others. The record does not support complaint counsel's assertions of agreement and coordination. [250]

Prior to 1970, the Council on Foods and Nutrition of the American Medical Association and the Food and Nutrition Board of the National Research Council both recommended that nutrients be added to foods only to the extent of restoring what was lost during

the manufacturing process. During the mid-1960's, the Food and Drug Administration publicly opposed fortifying RTE cereals beyond allowable limits, on the ground that the availability of vitamins to consumers from other sources made cereal fortification unnecessary. The FDA proposed a rule and instituted rulemaking proceedings to so limit fortification.

Notwithstanding the pronouncements of the Council on Foods and Nutrition of the American Medical Association and the Food and Nutrition Board of the National Research Council and the adverse position of the FDA, respondents engaged in considerable fortification activity prior to 1970.

However, there was limited consumer demand for fortified RTE cereals during the 1960's and only limited, temporary success for products that were fortified. The record fails to indicate that respondents' individual competitive efforts prior to 1970 in the field of product fortification were not fully commensurate with the public demand. There is no evidence that indicates that respondents reached agreements concerning, or coordinated, their pre-1970 fortification conduct.

In the late 1960's and early 1970's, there was a dramatic change in the national attitude toward the fortification of cereals. A White House Conference on Nutrition issued a report in December 1969 to the effect that there were significant nutritional deficiencies in the diets of large segments of the population. It recommended that the proposed 1966 FDA regulations barring the fortification of breakfast cereals not be adopted, because the widespread acceptance and consumption of breakfast cereals made them effective carriers of essential nutrients. It attacked the view that all needed nutrients were obtained from ordinary diets, and recommended strong food fortification programs. Consequently, the FDA abandoned its proposed rule to prohibit food fortification.

In July 1970, Mr. Robert B. Choate, in testimony before a congressional committee, criticized the lack of nutrients in RTE cereals. Mr. Choate's testimony was widely publicized and further increased industry and consumer interest in vitamin fortification.

Following the White House Conference on Nutrition report, the FDA reversal of position and the Choate testimony, the respondents became very heavily engaged in product fortification. Respondents' activities, however, were fully consistent with individual, competitive responses to stated public policy and consumer interest and demand.

While the respondents attended two meetings of the Cereal Institute shortly after Choate's testimony, respondents did not [251]

discuss plans regarding fortification at either meeting. No agreements were there made regarding fortification. There is no evidence that the respondents otherwise communicated regarding their fortification activity, or that any respondent had advance knowledge of the fortification plans of the others.

There is no basis, therefore, for an inference that respondents' fortification activities, which were most reasonable in the light of ongoing events, were in response to an otherwise unproved agreement rather than the ongoing events.

Complaint counsel assert that the RTE cereal industry is marked by high barriers to the entry of new firms and that there are no barriers to entry unrelated to respondents' conduct. The conduct so targeted by complaint counsel is brand proliferation which is asserted to provide the complete answer to lack of entry.

It is complaint counsel's position that respondents' avoidance of competition by other means led them to turn to brand proliferation, the introduction of a large number of differentiated, highly advertised trademarked brands; that, while brand proliferation is not in itself unlawful, respondents must be held responsible for its deterrent effects upon entry, since respondents turned to this method of competition as a result of their mutual avoidance of other means of competition.

Brand proliferation is nothing more than the introduction of new brands which is a legitimate means of competition. Respondents' brand proliferation is vigorously competitive and, as conceded by complaint counsel, is not predatory and not in itself unlawful. Respondents engaged in intense, unrestrained and uncoordinated competition in the introduction of new products. There is no evidence of a conspiracy or intent to deter entry by means of new product introductions.

Consumers' desire for variety for breakfast is responsible, in large measure, for the differentiation of RTE cereals. A firm in the RTE cereal industry must introduce new products in order to remain profitable and compete for market share.

Respondents, therefore, may not be held responsible for the results of this legitimate method of competition, unless it was the proximate result of their having otherwise limited their competitive efforts as charged. However, complaint counsel failed to prove those charges. Further, even if respondents had conspired or otherwise unlawfully coordinated their other competitive efforts, new product introduction would still have remained as a legitimate means of competition. No causal relationship has been shown between the alleged avoid-

ance of other methods of competition and competition by brand introduction.

This fully disposes of complaint counsel's effort to hold respondents liable under Section 5 by reason of having engaged in new [252]brand competition (proliferation). However, in order to provide complete findings for a reviewing authority, I examined complaint counsel's analysis of how brand proliferation allegedly created a barrier to entry and made numerous findings with respect to various steps in complaint counsel's theory. Without here repeating all of the elements of complaint counsel's theory and all of the findings, following is a reference to some of the more dispositive findings.

One of the requisite elements of the proliferation theory is that the market be localized or segmented so that each cereal competes almost exclusively in its own limited segment.

There are segments or categories of cereals which compete more strongly with each other because of their similar attributes. There are some cereals that are so similar that they compete with each other on a one to one basis. At the same time, some cereals may have a broader appeal than the particular segment or category they may fall in so that they compete to varying degrees with cereals outside of their particular category. The record, however, does not permit a delineation of the segments and the degrees to which competition among cereals is confined to cereals in particular segments or extends beyond such segments. The extent of the impact of localization, therefore, is unknown.

Complaint counsel assert that proliferation has crowded some segments to the extent that there is not sufficient opportunity for a new product. While crowding has undoubtedly deterred new entry into some areas, the areas so precluded, their economic significance, and the time periods of preclusion have not been identified.

Complaint counsel's assertion that the introduction of all of the products that can profitably compete in an area will dissuade the entry of still more products is not at all disturbing. It is just another way of saying that competition will deter entry and the more vigorous the competition, the more likely it is that new entry will be deterred. Complaint counsel have merely evidenced and analyzed how competition by existing firms in the form of new products will deter the introduction of still more products by new entrants.

There is a product efficiency of scale equal to about 1% of the market. Complaint counsel assert that firm efficiency of scale is not reached until sales of 3.5% to 5% of the market are achieved. It is argued that respondents, all of whom are already operating at or above firm efficiency of scale, can introduce a new product whenever

a 1% opportunity appears, whereas an outsider cannot; that an outsider is faced with the insurmountable task of finding and expensing three or more opportunities in order to enter the market at minimum firm economy of scale, so as not to be at a cost disadvantage to respondents.

Evidence of probative value on the issue of firm efficiency or economies of scale was found to be limited to a "Headen-McKie" study. Findings 629 and 641 pertain to the Headen-McKie report: [253]

629. The Headen-McKie conclusions on firm economies of scale have no analytical or other substantive support. As conclusions drawn from conversations with production managers, and limited to production costs, they are at best a rough estimate that firm economies of scale are not fully realized until a 5% market share is reached. However, the report does not indicate the difference in production efficiencies at the 1% and 5% levels or for points in between. Accepting the report at full value, it may be that, while firm economies of scale are fully realized at the 5% level, there is not a significant difference in firm efficiencies at the 1% and 5% levels.

641. In summary, under Headen-McKie, which does provide a rough estimate of production scale economies, it would be economically feasible to enter the RTE cereal market with production facilities capable of supplying about 1% of the national market. While the entrant could earn "satisfactory" profits at that level of production, it would not achieve full production economies of scale unless it supplied about 5% of the market. The study, however, does not indicate the degree of disadvantage that a firm would be under at various levels of production below 5% down to 1%. Even if a firm required 5% of the market to achieve minimum efficient scale, it would enter at a smaller volume if the cost disadvantage was not too great. It is impossible, therefore, to evaluate the extent to which preemption of new entrants by reason of their inability to achieve economies of scale has acted to deter entry (footnotes omitted).

While brand proliferation may well exert a deterrence on entry,<sup>99</sup> it is not the only deterrence. The situation has been summarized as follows in Findings 668-74:

668. Respondents have engaged in intense, uncoordinated competition in the introduction of new [254]products. This competition is not unlawful nor was it induced by other unlawful activity.

669. Obviously, the more successful new products introduced by respondents and other incumbents, the more saturated the market and the less requirement and opportunity for the introduction of new products by outsiders. By the very nature of differences in demand (*e.g.*, presweets, natural, fortified, bran, flavored), products are to a degree localized, and a new product would to a degree be limited as to the segment from which it could attract its users. Individual products account for lower market

<sup>99</sup> As noted above, the extent to which lack of entry in the RTE cereal industry may be explained by brand proliferation is an unknown quantity, because of a failure of proof of two of the elements upon which the theory rests. These are: (1) minimum firm efficient scale of entrance below which the new entrant would be at a significant competitive disadvantage to existing firms and (2) the degree of localization of RTE cereal products.

shares and smaller poundage of sales than formerly. The industry has become one of relatively small volume brands.

670. Incumbents are at an advantage over potential entrants in developing and marketing acceptable new products. They can utilize existing research and development, market research and other expertise in locating opportunities and developing products to meet perceived demand. They can also utilize unused capacity for production of a new brand, whereas a new entrant would have to build that capacity.

671. Respondents and other incumbents are not only capable of finding and taking advantage of an opportunity before a potential new entrant, but, because of economies of scale, are in a position to take advantage of smaller opportunities.

672. Would be entrants are faced with substantial fixed costs in research and development, market research, plant production equipment and introductory advertising. To the extent the requirement exists to introduce multiple products, the costs would multiply. Potential entrants, therefore, are limited to large firms, primarily those already producing and supplying grocery products who can utilize their existing expertise and so minimize costs of entry and operation.

673. The limited number of potential entrants would exercise caution in actually entering because of high capital costs, long lead times in developing and marketing acceptable products, extended periods even after entry in reaching levels of profitable operation and recovering capital investments, and the high risk that a product may prove unacceptable at various stages up to national entry or may fail after entry. Indeed, the problems of developing an acceptable product with which to enter may be insurmountable.

674. While potential entrants would be aware of the publicly reported profitability of Kellogg, they could not hope to emulate the most successful company. Their desire [255] to enter would be tempered by their observation of others in the industry. They would hesitate knowing of the failure of General Foods in marketing its cereals with fruit and its loss of market share, and of Nabisco's decline in market share. Potential entrants would also hesitate because of the observed inability of Pillsbury, Colgate, International Multifoods, and H.J. Heinz to remain in the market and the limited success of Pet.

Basic to complaint counsel's shared monopoly theory is the allegation that respondents have maintained a pattern of conduct that has enabled them to charge supracompetitive prices and to reap monopoly level profits; and that this demonstrates that they are sharing monopoly power. Complaint counsel have stated, "However, proof of monopoly power in this case rests primarily on the evidence that each of the respondents gained monopoly profits over a long period of time." Complaint counsel's theory of the existence of a barrier to entry into the RTE cereal industry is also premised, in part, on the assertion that the industry has enjoyed supracompetitive profits.

Complaint counsel have elected to measure and evaluate profits in terms of rates of return on capital employed. This is an appropriate means of measuring profits for purposes of this case and is preferable to other measures, such as return on equity or return on sales.

There are significant differences between accounting and economic rates of return. Upon an analysis of those differences and the

nature of the RTE cereal industry, it has been found that economic rate of return, not accounting rate of return, is the appropriate measure to be used in appraising profits enjoyed in the RTE cereal industry and in making comparisons among respondents, with other companies and with other industries.

Dr. Thomas R. Stauffer has devised a formula to determine the economic rate of return for an ongoing firm. This formula is a pioneering contribution in the field and was the subject of Dr. Stauffer's doctoral dissertation in economics at Harvard University. Other doctoral dissertations in economics at Harvard have applied his formula in the analyses of specific industries. The formula was applied by Dr. Stauffer in the instant case.

Dr. Stauffer's formula starts with an accounting rate of return and from it calculates an economic rate of return. In order to determine General Mills' and General Foods' accounting rate of return for RTE cereal, it was necessary to segregate and allocate portions of overall company accounting data covering multifacets of those companies' businesses that pertained to the RTE cereal segment of the company. Once this was done, there were various unknowns in the formula used to convert accounting rates of return to economic rates of return which had to be estimated. The results were then compared with a benchmark—the average economic rate of return on capital [256]employed for all firms in the manufacturing sector of the United States.

After applying allowable allocations to general company accounting data to reach accounting rates of return for RTE cereal, utilizing allowable estimates for the unknown factors in Dr. Stauffer's conversion formula, and adjusting the benchmark rate of return to exclude data for manufacturing companies which had no income, the following economic rates of return were arrived at:

	<u>Kellogg</u>	<u>General Mills</u>	<u>General Foods</u>	<u>Ralston</u>	<u>Benchmark</u>
1958-1970	11.7	10.5	7.3	9.9	10.3
1954-1972	13.2	10.1	6.7	10.7	10.1

This is not a finding of what respondents' and Ralston's economic rates of return have been, but rather that there is a lack of proof of any higher returns.

Probably because of the fact that Quaker's rate of growth exceeded its rate of return, Dr. Stauffer's formula was inappropriate to estimate Quaker's economic rate of return; and there is no record

evidence of that rate. There is record basis, however, for assuming that it was well below 9%, *i.e.*, well below the benchmark. The record also independently establishes that General Foods did not earn above-normal (supracompetitive) profits.

There are a number of considerations which bias the benchmark downward, *i.e.*, understate the average profits of the manufacturing sector when comparing them with the profits of RTE cereal companies. Two important factors that must be considered before meaningful comparisons may be made between RTE cereal companies' rates of return and the benchmark are (1) inflation and (2) risk.

Dr. Stauffer made no adjustments for inflation, since he was not trying to compute absolute levels of profitability, but rather to compare relative levels. However, the failure to account for inflation caused a greater upward bias on the computation of profits of the RTE cereal firms than on the benchmark.

A higher than average return is still considered competitive or normal if the amount above the average is compensation for above average risk. A normal rate of return for a business with above average risk would be greater than for less risky businesses. RTE cereal is a relatively high risk industry.

Thus, it has been found:

Finding 815. The benchmark derived from IRS data for the manufacturing sector cannot be deemed to [257]draw an absolute line of demarcation between normal and monopoly profits. While such IRS data have generally been relied upon by economists, there is concededly some degree of inexactitude (citations omitted; and note the various biases enumerated above). Further, the benchmark is simply an average of firms' earnings below the average and firms' earnings above the average. It cannot be said that every firm earning above average, whose rate of return contributed to reaching the average, is earning monopoly profits. Finally, while not quantified, considerations of inflation and risk establish a normal rate of return for the RTE cereal respondents at a somewhat higher level than an average benchmark.

Finding 816. In consideration of the above, while the benchmark may be used as a rough guideline to aid in evaluating rates of return, a rate of return cannot be said to be monopolistic or supracompetitive unless it is substantially in excess of the benchmark. That is not the case here. General Foods' rate of return is substantially below the benchmark. Quaker's return may be assumed to be below it (Finding 796). General Mills' and Ralston's rates of return approximate it. Only Kellogg is shown to have a rate of return in excess of the benchmark; and, in consideration of the variables and biases discussed above, its rate cannot be said to be substantially in excess.

Thus, complaint counsel's factual assertion basic to its shared monopoly theory, that respondents and others in the RTE cereal industry realized supracompetitive profits, fails for lack of proof.

Complaint counsel assert that respondents have not been innovative in their efforts to bring new and better products to consumers;

that their new product developments have been essentially variations of existing RTE cereal products rather than innovations.

Complaint counsel are thus raising a question of the consumer welfare significance of new product introductions. This is not a matter for my judgment in this case. Any product that expands the choices of a consumer is an innovation. The significance of an innovation is determined by its success in the marketplace. As stated in Finding 840:

There is no reason to believe that respondents have not attempted to come up with all reasonable innovations consistent with anticipated consumer acceptance. Neither complaint counsel nor I are in a position to pass judgment on what, if any, additional significant innovations the industry could or should have come up with. It cannot be found that [258]something more dramatic should have been developed, or that there are areas where innovativeness was neglected. The only area specifically alleged by complaint counsel to have been neglected is that of product fortification, and that allegation has been found to be unsubstantiated (footnote omitted).

Complaint counsel assert that advertising cost levels in the RTE cereal industry are excessive and wasteful. While the advertising-to-sales ratio for the RTE cereal industry is almost at the top of all manufacturing industries, RTE cereal industry advertising cannot be found to be excessive.

Advertising performs a necessary and legitimate function of advising prospective customers of the attributes of products offered for sale. The large number of nonhomogeneous RTE cereal products, each with its requirement for separate advertising, dictates a relatively high A/S ratio. This requirement is further impacted by the high incidence of new product introduction which necessitates high levels of advertising.

It may well be that levels of advertising, to some extent, are being raised to achieve additional returns depending on the gross profit margins being realized (the Dorfman-Steiner principle). However, it is not improper for a manufacturer to increase advertising to the point of realizing all possible marginal returns. In the absence of a showing that respondents were earning supracompetitive profits, their advertising levels, even to the extent they may be based on marginal returns, cannot be termed inefficient or wasteful.

As summarized in Finding 870:

. . . I start with the basic assumption that advertising is a viable and legitimate method of competition. And complaint counsel have failed to demonstrate that the large volume of advertising in the RTE cereal industry does not have a competitive basis or that it reflects the existence of supracompetitive profits. A firm advertises in order to generate or increase sales and so increase profits. At the same time, once profits are realized, or in anticipation of profits, the firm may increase advertising up to the point of realizing all possible marginal returns. This, however, is pure theory

and no findings can be made as to the extent respondents have increased normally competitive advertising levels to take advantage of the Dorfman-Steiner principle.

It is not appropriate to mandate a "socially optimal level" of advertising as a substitute for one reached as a result of [259] competitive considerations. Our concept of a free competitive system does not envision imposition by government of permissible levels of advertising.

To establish the existence of a conspiracy to monopolize, the following elements are necessary: (1) the existence of a combination or conspiracy; (2) overt acts done in furtherance of the combination or conspiracy; (3) an effect upon a substantial amount of interstate commerce; and (4) the existence of specific intent to monopolize. *Cullum Electric & Mechanical Inc. v. Mechanical Contractors Association of South Carolina*, 436 F.Supp. 418, 425 (D.S.C. 1976), *aff'd*, 569 F.2d 821 (4th Cir. 1978), *cert. denied*, 439 U.S. 910 (1978).

Conspiracy is an agreement by two or more persons to pursue a common goal or objective having an unlawful purpose. *Standard Oil Co. of California v. Moore*, 251 F.2d 188, 196 n. 3 (9th Cir. 1957), *cert. denied*, 356 U.S. 975 (1958). However, a conspiracy need not be demonstrated by evidence of an express agreement. *Comfort Trane Air Conditioning Co. v. Trane Co.*, 592 F.2d 1373 (5th Cir. 1979); *FTC v. Lukens Steel Co.*, 454 F.Supp. 1182 (D.D.C. 1978). Direct evidence is not required because of the general recognition that:

... seldom are the conspiratorial villains so devoid of cleverness as to broadcast their oral agreements or publicly circulate the written memos which describe their plan.

*Rutledge v. Electric Hose and Rubber Co.*, 327 F. Supp. 1267, 1274 (C.D. Ca. 1971), *aff'd*, 511 F.2d 668 (9th Cir. 1975).

While the essence of conspiracy is agreement or a "meeting of the minds," tacit understanding can be found by mere acquiescence or acceptance of an invitation to participate in a plan, if each competitor knows that cooperation is essential to the success of the plan. *Interstate Circuit, Inc. v. United States*, 306 U.S. 208 (1939); *Wall Products Co. v. National Gypsum Co.*, 326 F. Supp. 295, 316 (N.D. Ca. 1971). If people with knowledge give adherence to a plan, acquiescence is sufficient to establish a tacit agreement.

Tacit agreement can be inferred from circumstantial evidence of conduct or a course of dealing even though there is no evidence of the acts by which the conspiracy was formed. *Interstate Circuit, Inc. v. United States*, 306 U.S. 208 (1939); *Overseas Motors, Inc. v. Import Motors Limited, Inc.*, 375 F. Supp. 499 (E.D. Mich. 1974), *cert. denied*, 423 U.S. 987 (1975).

The use of circumstantial evidence to infer a conspiracy presents

problems of proof. The evidence must create more than a suspicion of wrongdoing. *Admiral Theatre Corp. v. Douglas Theater Co.*, 585 F.2d 877, 884 (8th Cir. 1978). As stated in *Overseas Motors, Inc. v. Import Motors Limited, Inc.*, 375 F. Supp. at 531: [260]

There is a limit, however, to the degree of indirection and innuendo which the law will tolerate. Where . . . the plaintiff's case is based entirely on such circumstantial evidence, the court must be especially vigilant to insure that liberal modes of proof do not become the pretext for unfounded speculation.

Therefore, courts are cautious and consider the circumstantial evidence as a whole rather than viewing it in isolation. *American Tobacco Co. v. United States*, 328 U.S. 781 (1946); *Continental Ore Co. v. Union Carbide & Carbon Co.*, 370 U.S. 690, 699 (1962).

Consciously parallel conduct is circumstantial evidence that competitors have acted pursuant to a tacit agreement. Standing alone, however, parallel business behavior does not constitute violation of the antitrust laws. The Supreme Court has stated that:

. . . this Court has never held that proof of parallel business behavior conclusively establishes agreement or, phrased differently, that such behavior itself constitutes a Sherman Act offense. Circumstantial evidence of consciously parallel behavior may have made heavy inroads into the traditional judicial attitude toward conspiracy; but "conscious parallelism" has not yet read conspiracy out of the Sherman Act entirely (footnote omitted).

*Theatre Enterprises, Inc. v. Paramount Film Distributing Corp.*, 346 U.S. 537, 541 (1954).

The fact that conduct is parallel or occurred near in time may be an independent response to a common set of market factors. The coincidence of parallel decisionmaking does not justify inference of tacit agreement if action is based on sound business judgment. *Schoenkopf v. Brown & Williamson Tobacco Corp.*, 483 F. Supp. 1185, 1191 (E.D. Pa. 1980), *aff'd*, 637 F.2d 205 (3rd Cir. 1980); *Hunt v. Mobil Oil Corp.*, 465 F. Supp. 195, 228-29 (S.D.N.Y. 1978), *aff'd*, 610 F.2d 806 (2nd Cir. 1979); *Harlem River Consumers Cooperative, Inc. v. Associated Grocers of Harlem, Inc.*, 408 F. Supp. 1251, 1278 (S.D.N.Y. 1976). As stated in *Independent Iron Works, Inc. v. United States Steel Corp.*, 177 F. Supp. 743, 747 (N.D. Ca. 1959), *aff'd*, 322 F.2d 656 (9th Cir. 1963), *cert. denied*, 375 U.S. 922 (1963):

The antitrust laws were not meant to prohibit businessmen from adopting sound business policies [261]merely because competitors had already adopted the same or similar policy.

As with other parallel conduct, uniformity of price, without more, is not evidence of collusion. See *United States v. FMC Corp.*, 306 F.

Supp. 1106, 1117 (E.D. Pa. 1969). Mere leadership or price followership based on independent decisionmaking violates no law. *United States v. International Harvester Co.*, 275 U.S. 693, 708-09 (1927).

Thus, it has been held that price uniformity alone is insufficient to establish an antitrust violation because it may be the normal result where a product is standardized or fungible, even though there is no agreement between competitors and the costs for the participating companies are not the same. See *FTC v. Lukens Steel Co.*, 454 F. Supp. at 1190. Where there is an oligopoly involved in the production of a standardized product, such as salt, for which the demand is stable, it is inevitable that pricing policies of one company would influence the other. Therefore, other factors should be considered in addition to the parallel pricing. See, e.g., *Morton Salt Co. v. United States*, 235 F.2d 573 (10th Cir. 1956).

Because evidence of parallel business behavior alone is not sufficient to support an inference of conspiracy, courts have required additional factors to show that the parallel decisions were interdependent. See *Levitch v. Columbia Broadcasting System, Inc.*, 495 F. Supp. 649, 674 (S.D.N.Y. 1980). The additional circumstances which support the inference are: (1) a showing that the acts by defendants are in contradiction to their own economic interests and (2) a satisfactory demonstration of a motivation to enter an agreement. *Venzie Corp. v. United States Mineral Products Co.*, 521 F.2d 1309, 1314 (3rd Cir. 1975).

Action against apparent individual self-interest is a strong indication of interdependence and tacit agreement among competitors. *Modern Home Institute Inc. v. Hartford Accident and Indemnity Co.*, 513 F.2d 102, 111 (2nd Cir. 1975). Parallel conduct which is complex, original, unanimous or corresponds exactly, especially where it is an abnormal reaction to market stimuli and inconsistent with each company's economic self-interest, strengthens the inference. *Overseas Motors, Inc. v. Import Motors Limited, Inc.*, 375 F. Supp. at 535; *Trist v. First Federal Savings and Loan Association of Chester*, 466 F. Supp. 578, 581 (E.D. Pa. 1979).

Motive to enter an agreement can be inferred from a pattern of conduct and can reasonably be drawn from the facts presented. *First National Bank of Arizona v. Cities Services Co.*, 391 U.S. 253, 287 (1968); *American Tobacco Co. v. United States*, 328 U.S. 781 (1946). Proof of motivation is evidence which makes "the inference of rational, independent choice less attractive than that of concerted action." *Bogosian v. Gulf Oil Corp.*, 561 F.2d 434, 446 (3rd Cir. 1977), cert. denied, 434 U.S. 1086 (1978). [262]

The ultimate determination is whether the evidence reveals

conduct that can be explained by rational, independent business behavior or could only make sense in the context of the behavior of others. If the letter is true and the behavior only makes sense if each respondent's competitors behave in a similar fashion, then the inference of concerted action may be warranted. *FTC v. Lukens Steel Co.*, 454 F. Supp. at 1191. However, circumstantial evidence is not sufficient to establish a conclusion where the circumstances are merely consistent with such a conclusion or where they give equal support to inconsistent conclusions. *Pevely Dairy Co. v. United States*, 178 F.2d 363, 370 (8th Cir. 1949), *cert. denied*, 339 U.S. 942 (1949).

If the proof supports the inference of tacit agreement, the burden then rests on respondents to explain it away or to contradict it. *Interstate Circuit, Inc. v. United States*, 306 U.S. 208 (1939); *Milgram v. Loew's, Inc.*, 192 F.2d 579, 584 (3rd Cir. 1951), *cert. denied*, 343 U.S. 929 (1952). The inference can be overcome where there is direct evidence that the action was taken unilaterally for sound business reasons. See, e.g., *Feminist Women's Health Center, Inc. v. Mohamad*, 586 F.2d 530, 549 (5th Cir. 1978), *cert. denied*, 444 U.S. 924 (1979).

In considering the implications of the respondents' behavior, it is important to stress the Supreme Court's admonition that:

. . . each case arising under the Sherman Act must be determined on the particular facts disclosed by the record, and that the opinions in those cases must be read in the light of their facts and of a clear recognition of the essential differences in the facts of those cases, and in the facts of any new case to which the rule of earlier decisions is to be applied.

*Maple Flooring Manufacturers Ass'n v. United States*, 268 U.S. 563, 579 (1925).

In the instant case, there has been a total failure to demonstrate pricing coordination among respondents. There is, therefore, no coordinated pricing activity concerning which the possibility of tacit agreement may be considered.

Complaint counsel have failed to prove the alleged coordination or agreement among respondents with respect to trade deals, cents-off deals, in-pack premiums, private labeling, advertising, competition for retail shelf space or fortification of cereals. In any event, respondents have established that their actions were independent responses to similar economic and market conditions or to particular conditions facing an individual respondent. [263]

The only coordinated activity alleged and proved was the exchange of advertising data. However, the data so acquired were not utilized in a noncompetitive fashion. The exchange of nonprice information

alone is not a violation of the Sherman Act. *FTC v. Lukens Steel Co.*, 454 F. Supp. at 1191-92. See *Maple Flooring Manufacturers Ass'n v. United States*, 268 U.S. 563, 582 (1925).

It has been concluded, therefore, that respondents did not violate Section 5 of the Federal Trade Commission Act by reason of conspiracy.

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Complaint counsel have presented their shared monopoly theory under a structure-conduct-performance approach, and have conceded that an oligopolistic structure alone does not constitute a violation of Section 5; that it is also necessary to show the existence and exercise of monopoly power.

Structure consists of two elements: (1) degree of concentration and (2) extent of barriers to entry. The RTE cereal industry is one of the most highly concentrated industries in the United States. However, there has been a failure of proof that the industry members have been enjoying monopoly profits, a condition under which it may be argued that there would have been entry if there were no barriers to entry. Further, it has been found that respondents may not be held responsible for the lack of entry into the RTE cereal industry.

As for conduct, there has been a lack of proof that respondents have engaged in the coordinated conduct alleged as part of complaint counsel's theory of violation.

This brings us finally to performance where complaint counsel have failed to prove the monopolistic performance alleged as part of their theory of violation, i.e., that respondents earned supracompetitive or monopoly profits; that respondents have not been innovative in new product development; that respondents have been wasteful in advertising expenditures; and that respondents' prices have been so high that there has been a lessened demand for and supply of RTE cereals with a resultant waste and misallocation of society's resources.

Section 5 of the Federal Trade Commission Act was designed to reach unfair methods of competition which do not achieve the level of Sherman Act violations. *FTC v. Motion Picture Advertising Service Co.*, 334 U.S. 392 (1953); *Fashion Originators' Guild of America, Inc., v. FTC*, 312 U.S. 457 (1941); *FTC v. Cement Institute*, 333 U.S. 683 (1948).

The scope of Section 5 is not bound by Section 2 of the Sherman Act. Therefore, conduct which threatens an incipient violation of [264]the Sherman Act can amount to a Section 5 violation. See, e.g.,

*L.G. Balfour Co. v. FTC*, 442 F.2d 1 (7th Cir. 1971); *Borden, Inc.*, 92 F.T.C. 669, 781 n. 4 (1978). The Supreme Court has stated that the Federal Trade Commission has "authority to consider public values beyond simply those enshrined in the letter or encompassed in the spirit of the antitrust laws." *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 244 (1972).

The Supreme Court has set some parameters as to what kinds of commercial conduct can constitute a Section 5 violation, declaring:

The point where a method of competition becomes 'unfair' within the meaning of the act will often turn on the exigencies of a particular situation, trade practices, or the practical requirements of the business in question.

*FTC v. Motion Picture Advertising Service Co.*, 344 U.S. 392, 396 (1953).

Conduct has been found to be unfair in violation of Section 5 if it has the effect of increasing monopoly power to the detriment of competition. See, e.g., *Sugar Institute, Inc. v. United States*, 297 U.S. 553, 598 (1936); *Maple Flooring Manufacturers Ass'n v. United States*, 268 U.S. 563, 586 (1925). As Administrative Law Judge Brown has recently stated:

Section 5 of the Federal Trade Commission Act can be invoked to effect structural changes in an industry only where it is clearly demonstrated that the competitive disequilibrium is the result of some conduct that could be designated as 'unfair.' If the challenged conduct is not unreasonable and not the cause of the trend toward monopoly power, no violation of Section 5 exists, merely because the effects upon competition may be undesirable from an economic point of view.

*E. I. DuPont de Nemours*, 3 Trade Reg. Rep. ¶ 21,613 at 21,750, *aff'd*, by the Commission, ¶ 21,770 (1980).

In *Boise Cascade Corp. v. FTC*, 637 F.2d 573 (9th Cir. 1980), the court considered whether industrywide use of a delivered pricing system was a collusive practice to fix prices and whether it could be condemned under Section 5. The court refused to resolve the question whether conscious parallelism might ever support a Section 5 violation. However, it did find that: [265]

... in the absence of evidence of overt agreement to . . . avoid price competition, the Commission must demonstrate that the challenged pricing system has actually had the effect of fixing or stabilizing prices. Without such effect, a mere showing of parallel action will not establish a Section 5 violation.

*Id.* at 577.

Finally, the court noted that:

... where the parties agree that the practice was a natural and competitive development in the emergence of the southern plywood industry, and where there is a

complete absence of evidence implying overt conspiracy, to allow a finding of a Section 5 violation on the theory that the mere widespread use of the practice makes it an incipient threat to competition would be to blur the distinction between guilty and innocent commercial behavior.

*Id.* at 582.

It would serve no purpose to consider in a vacuum what factual showing, if any, of industry structure, conduct and performance would constitute a "shared monopoly" violation of Section 5, and might justify an order restructuring an industry. Such a showing has not been made here.

#### FINAL CONCLUSIONS OF LAW

1. Respondents Kellogg Company, General Mills, Inc. and General Foods Corporation were, at all times material herein, corporations engaged in commerce, as "commerce" is defined in the Federal Trade Commission Act.

2. The complaint does not encompass a charge of conspiracy. Counsel supporting the complaint have failed to sustain, the burden of establishing that respondents, or any of them, have violated Section 5 of the Federal Trade Commission Act. This finding of failure of proof relates, *inter alia*, to the issue of conspiracy, which was tried though not covered by the complaint. [266]

#### ORDER

*It is ordered,* That the complaint in this proceeding be, and it hereby is, dismissed as to all respondents.

#### ORDER DENYING APPEAL AND VACATING INITIAL DECISION

The Commission has determined not to hear further appeal of this matter. The Commission has also determined that the Initial Decision shall not become the final decision of the Commission. Thus,

*It is ordered,* That, the Initial Decision in Docket No. 8883 be vacated in its entirety, and the Commission's complaint in this matter be, and it hereby is, dismissed with prejudice.

Commissioner Pertschuk dissented as to denial of the appeal.

#### SEPARATE STATEMENT OF COMMISSIONER CLANTON

This case raises important issues concerning the application of Section 5 of the FTC Act to oligopolistic conduct. Because of these

issues and the present posture of this case—Administrative Law Judge Berman's decision in favor of respondents coupled with the Bureau Director's decision not to appeal—it seems highly desirable for the Commission to determine now whether a full briefing on the merits is warranted.

Of course, even in the absence of an appeal, the Commission has the right under Section 3.53 of the Rules of Practice to undertake a thorough review of the record. However, I believe the circumstances of this case justify an exception to that practice. Given the theories of liability and proposed relief under consideration, it is entirely proper for us to see if there is a likely basis for issuing an order, even if the facts conform closely to what complaint counsel contend.

After having reviewed the parties' most recent submissions, in response to the Commission's order of December 18, 1981, as well as other parts of the record, I cannot find a basis for continuing the case. In its most succinct form, complaint counsel urge that liability be premised on the basis of two related but distinct theories. The first is a traditional conspiracy to monopolize based upon the principles contained in Section 2 of the Sherman Act; the second is a shared monopoly theory under Section 5 of the FTC Act, a theory which does not depend upon a showing of collusion. Under either of these theories, complaint counsel argue that the only effective form of relief would be a divestiture order, including royalty-free licensing of respondents' cereal trademarks.

As to the first theory, I agree with ALJ Berman that a conspiracy to monopolize was not properly pled. As for the separate shared monopoly theory, I do not believe such a theory, however characterized, can serve as a predicate for the Commission to restructure an industry, at least in the absence of clear predatory behavior, which is not claimed here.

I do want to emphasize, however, that Section 5 may well provide the Commission with sufficient authority to attack non-collusive behavior that contributes to or enhances anticompetitive conduct, and which is without compelling business justification. In such circumstances, the principal remedial tool for dealing with this kind of behavior would be a conduct order. [2]

Before elaborating further on these points, I would offer a comment about the characterizations, or mischaracterizations, that have been advanced in the past by critics of this case. An awful lot of rhetoric has been spilled on this subject, with some critics claiming that the case is just the first step in a broad-based attack on concentrated industries. Others have accused the agency of attacking competitive forms of behavior, such as product differentiation

and brand proliferation; while still others have derided the "shared monopoly" concept, suggesting that this is evidence alone of the Commission's confused thinking since the description itself is a contradiction in terms.

Suffice it to say, I do not share all of the views of the critics of this case. In issuing the complaint, I think the Commission sought to address a legitimate concern, not about oligopolies *per se*, but rather about oligopolistic behavior that is uniquely anticompetitive. Respected antitrust commentators of different persuasions—such as Professor Posner and Professors Areeda and Turner—have advocated different approaches for dealing with collusive-type behavior among oligopolists.<sup>1</sup> Whether the theories of relief proposed by complaint counsel are proper is one thing, but it is clear to me that the Commission was not attempting through this case to challenge structure or bigness *per se*.

### *Conspiracy to Monopolize*

As one of their principal prongs of liability, complaint counsel now contend that an implied conspiracy to monopolize can be inferred from respondents' course of dealing over the past twenty years. It is contended that respondents have consistently eschewed various forms of price competition and channelled their energies instead into promotional activities and brand diversification.<sup>2</sup> Whether this conduct gives rise to a conspiracy to monopolize can be addressed only if a conspiracy in fact was properly tried. [3]

In finding that a conspiracy theory was not part of the case, ALJ Berman looked to the language of the complaint and statements made by complaint counsel during the prehearing conference stage of the proceedings. In particular, he found the complaint ambiguous, since it didn't mention specifically that either an agreement or conspiracy was at issue. Rather, the complaint charged, *inter alia*, that respondents "individually and collectively, have obtained,

<sup>1</sup> See P. Areeda & D. Turner, III *Antitrust Law*, Ch. 8E (1978); R. Posner, *Antitrust Law: An Economic Perspective*, 39-77 (1976).

<sup>2</sup> Complaint counsel's conspiracy case depends primarily upon a showing that respondents' roughly parallel behavior on several fronts—instituting price changes, stopping trade deals, eliminating in-pack premiums, refusing to sell to private labelers, fortification—over a twenty year period cannot be explained away as a coincidence of independent judgments. While it is unnecessary to delve into this issue at any great length, since the conspiracy theory, as discussed hereinafter, is not properly before us, I would observe that this kind of evidentiary approach to proving collusion is not unprecedented. Cases such as *American Tobacco Co. v. United States*, 328 U.S. 781 (1946) and *Wall Products Co. v. National Gypsum Co.*, 326 F. Supp. 295 (N.D. Cal. 1971), indicate quite clearly that conspiracy can be inferred from proof of parallel actions coupled with economic conditions that appear to negate an inference of innocent, independent business conduct. This point is not to suggest that the case before us unquestionably involves a conspiracy, for, among other things, the evidence of simultaneity of behavior, (e.g., price leadership) here is perhaps not as strong as it was in the aforementioned cases. What it does suggest is that a conspiracy theory is not impotent to deal with oligopolistic behavior that exhibits more than a casual trend toward interdependent conduct.

shared and exercised . . . monopoly power in, and have monopolized, the production and sale of RTE cereal . . ." (Complaint, ¶9B). More importantly, ALJ Berman noted that complaint counsel had emphatically denied on several occasions early in the proceedings that the complaint contained a conspiracy count. (I.D. at pp. 3-10) Thus, although the first ALJ (Judge Hinkes) subsequently allowed the case to be tried on a tacit conspiracy theory, ALJ Berman found that procedure deficient since the complaint was not amended by the Commission and respondents did not acquiesce to that procedure. (See Rules of Practice Section 3.15) [4]

A review of the record indicates that, at best, the conspiracy pleading issue is murky. Obviously, we should not engage in excessive nitpicking of pleadings or overly technical interpretations, but the pleadings are not a model of clarity, especially in light of the shared monopoly theory being alleged. Words such as "combination" and "collectively" are used in the complaint, but those words are also consistent with a shared monopoly theory that requires no showing of collusion. Nevertheless, the pleadings might have been adequate to encompass a conspiracy to monopolize theory had it not been for complaint counsel's insistent denials that a conspiracy was at issue in the case.

During the prehearing conferences in 1972, ALJ Hinkes on more than one occasion sought further clarification of the pleadings from complaint counsel in view of their simultaneous denial of conspiracy and assertion that the case focused on joint, interdependent conduct. (Tr. 17, 25, 71, 104) After several tries, complaint counsel finally indicated that the case could encompass a tacit agreement (Tr. 106-08, 163-64), but only after having previously indicated that no traditional conspiracy was being alleged.<sup>3</sup>

Of course, as ALJ Berman noted, traditional conspiracies, under either Section 1 or Section 2 of the Sherman Act involve both express and tacit agreements. Thus, it seems hard to conclude that the case, as originally envisioned, encompassed a traditional Sherman Act-type conspiracy. Yet, that is precisely what complaint counsel now contend has been established in this case—a traditional Section 2, Sherman Act conspiracy to monopolize. (Complaint Counsel's Proposed Conclusions of Law, Vol. IV at 655-90, Sept. 30, 1980) Even giving the benefit of the doubt to complaint counsel, it is hard to understand why it was necessary to dance step around the conspiracy issue if the case clearly covered it. After all, the major case now

<sup>3</sup> Although the pleading issue was not before the court, it is interesting to note that the D.C. Circuit Court of Appeals, in a subpoena enforcement action brought four years after the case was filed, observed that a conspiracy was not alleged in the complaint. *FTC v. Lonning*, 539 F. 2d 202, 204, n. 3 (D.C. Cir. 1976).

relied upon by complaint counsel, *American Tobacco Co. v. United States*, 328 U.S. 781 (1946), which was decided twenty-five years before this case was brought, involved an implied conspiracy to monopolize. While there have not been many implied conspiracy cases brought under Section 2, there certainly have been numerous such cases under Section 1, and complaint counsel, in fact, cite to such precedent in support of their case. [5]

Perhaps, in denying that a conspiracy was at issue in the case, complaint counsel may have been attempting to distinguish between Section 1-type conspiracies and Section 2 conspiracies. There is, however, no evidence of that and, in any event, such a distinction would appear to be unnecessary since the type of proof needed to establish a conspiracy would appear to be much the same regardless of which provision of the Sherman Act was being pleaded. See P. Areeda & D. Turner, *supra*, note 1, ¶839. Alternatively, complaint counsel may have felt that the kind of tacit conspiracy they had in mind would not rise to the Sherman Act level, but if that is the case then the issue is little different from the pure Section 5 shared monopoly theory discussed below. There can hardly be two kinds of conspiracies, one sufficient to establish Sherman Act liability and another sufficient for Section 5 purposes.

To be sure, there have been suggestions that the scope of the conspiracy theory under the Sherman Act could be broadened to give greater emphasis to the use of economic evidence in determining whether a tacit conspiracy exists. See R. Posner, *supra*, note 1, at 71-77. Still, the issue is whether a conspiracy exists, not whether some other theory, by a different name, is viable.

Although ALJ Hinkes ultimately allowed the conspiracy charge to be tried, it is clear that the parties did not agree on this procedure and that no amendment to the complaint was sought from the Commission. Accordingly, I do not believe the Commission can hinge liability on a conspiracy theory.

#### *Section 5 Shared Monopoly*

Even if a conspiracy count is not present, that does not end the matter. Complaint counsel alternatively argue that even absent a conspiracy the conduct is sufficiently like one to justify a finding of liability under Section 5 of the FTC Act. It is quite clear, of course, that Section 5 can reach anticompetitive behavior that is not covered by the Clayton or Sherman Acts. And, I believe such authority

extends to non-collusive, marketwide behavior that may not involve traditional forms of predation.<sup>4</sup> Presumably, this could include behavior that would not be illegal for a single firm to engage in but, due to the industrywide nature of the practice, could lead to significant anticompetitive effects. [6]

Various commentators have also urged that the antitrust laws are flexible enough to deal with shared monopolies or oligopolistic behavior outside the context of a traditional conspiracy.<sup>5</sup> In highly concentrated industries competitors may learn to react to each others' moves in a fashion that is closely analogous to the workings of a cartel. Firms will recognize that it is not in their self-interest to chart an independent course because other competitors will be able to quickly detect and match their moves, thereby leading to lower profits for the industry as a whole. The degree to which this phenomena occurs, and its success, are obviously subjects of great debate and the identification of markets in which firms are operating in a closely interdependent fashion is admittedly complex.

Because of the difficulties in proving collusion, Professors Areeda and Turner have advocated a different approach to the problem of single firm monopolization and shared monopolies. In their recent treatise, they suggest that evidence of persistent monopoly performance in a market, whether exhibited by a single firm or a small group of firms, should be sufficient to justify sweeping relief in the form of divestiture or other like remedies. Of course, they would require fairly strong evidence that the market is performing badly and that structural remedies would not lead to inefficiencies. They also believe that such actions should be limited to government initiatives and not allowed in private suits. In essence, their proposal does not depend on improper conduct for establishing liability and is akin to various no-fault monopoly proposals that have been advanced in the past.

But even Areeda and Turner recognize that the kinds of markets that might warrant intervention under such an approach are limited, even more so in the shared monopoly area than for single firm monopolies.<sup>6</sup>

Complaint counsel, of course, are not advocating a no-fault approach in this case. Instead, they have attempted to develop their case in a way that focuses on the extent to which respondents' interrelated behavior has exacerbated competitive problems in the RTE cereal industry. Their theory depends less on the unreasona-

<sup>4</sup> See, e.g., *Boise Cascade Corp., et al.*, 91 F.T.C. 1 (1978), *rev'd on other grounds, Boise Cascade Corp. v. FTC*, 637 F.2d 573 (9th Cir. 1980).

<sup>5</sup> E.g., P. Areeda & D. Turner, *supra*, note 1; L. Sullivan, *Handbook of the Law of Antitrust*, Section 125 (1977).

<sup>6</sup> See P. Areeda & D. Turner, *supra*, note 1, ¶845.

bleness of specific forms of behavior than it does on the totality of the conduct. [7]

Nevertheless, even under complaint counsel's theory, one must recognize the implications of using such an approach to restructure an entire industry. As complaint counsel acknowledge, the kind of theory and relief they are seeking require extensive proof of industry structure, performance and conduct. While that kind of analysis is highly commendable, it provides a less than certain guide as to what kinds of conduct or market conditions would be subjected to antitrust attack. In addition, such an approach, of necessity, dramatically limits the number of instances where market intervention is warranted and, even then, it does not fully remove the risks associated with developing a structural remedy for an industry.

Thus, absent collusion or clear evidence of predatory behavior, I believe it would be unwise for the Commission to seek dissolution of an industry on the basis of the cumulative effects of multi-firm behavior. That does not mean, however, that such behavior would go unaddressed. Rather, it means that the kind of relief sought—namely, conduct remedies—would reflect two realities about the oligopolistic market context: (1) the lower probability that serious anticompetitive problems will exist for long, and (2) the potentially greater costs of attempting to restructure an industry. Because of the complexity involved, it may take many years to recover the costs of obtaining and implementing a successful dissolution order. Those costs may be worth incurring where we can be fairly confident that the market behavior under attack cannot be justified. The rigor of conspiracy analysis can help to provide that assurance, and strong evidence of predatory behavior may also provide the necessary predicate for divestiture.

But to pursue structural relief in less compelling circumstances carries with it too great a risk of wrong or imperfect judgments. The alternative, conduct relief, obviously has its limitations. Such a focus, however, enables more precise judgments to be made about the reasonableness of particular behavior without the risk of overkill.<sup>7</sup> To [8]be sure, conduct relief may not be feasible in all oligopolistic market settings, but neither is divestiture. After all, antitrust deals primarily with probabilities. Where the probable benefits of improving competition are very high, as they are in breaking up a

<sup>7</sup> Apart from their suggested approach for dealing with persistent shared monopoly, Areeda and Turner also have expressed the view that the antitrust laws even more clearly can reach exclusionary behavior engaged in by shared monopolists. Such a theory would, they believe, amount to a logical extension of attempted monopolization, since the primary missing ingredient would be the absence of a dangerous probability of a single firm monopoly. P. Areeda & Turner, *supra*, note 1 ¶ 856-61. Whether the courts would be willing to extend Section 2 of the Sherman Act this far is not clear, but, in any event, such an approach would appear to be within the scope of ¶5 of the FTC Act.

horizontal price-fixing conspiracy, there is little risk that the imposition of harsh sanctions will chill desirable competitive behavior. But, as the difficulty of distinguishing between harmful and beneficial conduct increases, so does the danger of imposing maximum remedies. Therefore, in my view, remedial restraint is called for, even in the kind of tightly concentrated market presented to us here, where profitability is good, market shares are stable and new entry has been minimal.

Although I am opposed to structural remedies, I reiterate my belief that the Commission can reach non-collusive, industrywide behavior under Section 5 of the FTC Act. An example of such an approach is the Commission's decision in *Boise Cascade*, 91 F.T.C. 1 (1978), *rev'd*, *Boise Cascade Corp. v. FTC*, 637 F.2d 573 (9th Cir. 1980). There, the Commission found that the industrywide use of an artificial freight factor contributed to price stability and could not be justified by market exigencies. Although the Ninth Circuit Court of Appeals felt that the Commission did not make a satisfactory showing of anticompetitive effect, the appellate decision did not foreclose the possibility that the Commission could employ Section 5 to reach unjustified forms of non-collusive behavior which are practiced on a marketwide basis. It should also be emphasized that the Commission in *Boise Cascade* believed that it could fashion an effective conduct order that would not be highly regulatory in nature. If conduct relief can be easily evaded, or requires extensive government intrusion in ongoing market operations, there is little reason to press ahead. And, the absence of effective relief may suggest that there are offsetting competitive justifications for the practices under scrutiny.

As reflected in the *Boise Cascade* decision, the Commission may address multi-firm behavior that facilitates non-competitive conduct as well as more exclusionary forms of conduct. On the other hand, simply refusing to compete, by itself, probably would not be subject to attack—to do so would be analogous to going after a passive monopolist. However, passivity in an oligopolistic context is harder to maintain without resort to collusion or other practices that may contribute to a stable market.

In this instance, assuming complaint counsel's case were to be established, several practices might be singled out for [9]possible action. For example, a central issue in the case is brand proliferation. Complaint counsel argue that respondents have engaged in excessive product differentiation as a less disruptive form of competition than price competition. It is claimed that by carving up the market into smaller and smaller product segments, respondents

have made it extremely difficult for new firms to enter, since an entrant would have to offer several brands to achieve minimal scale economies. Moreover, a new firm could not expect established competitors to give much ground, as might be the case if limit pricing were being practiced, because of the difficulty of repositioning brands.

Without getting into an extended discussion of these allegations, there does seem to be considerable evidence that brand proliferation has made entry more difficult. But that is not the end of the analysis. Whatever the social value of these products, we are not dealing with the kind of product design or change that is introduced primarily as a blocking device to discipline competitors.<sup>8</sup> In other words, we are not talking about predatory conduct that serves little, if any, legitimate competitive ends. For the most part, the myriad cereal brands on the market are self-sustaining and they appear to generate significant consumer demand. Even if we would prefer to see fewer brands and more price competition, it would be extremely difficult to distinguish between legitimate and illegitimate brand proliferation. Certainly, it would be quite inadvisable and impractical to attempt to limit advertising expenditures or new brand offerings. Thus, an order provision directed to this practice does not seem very promising.

A second practice that might be susceptible to correction concerns respondents' shelf space recommendations to grocery retailers. These plans rely largely on past market shares as the benchmark for allocating space. Complaint counsel contend that these recommendations, which many retailers have adhered to in principle, tend to stabilize competition among existing competitors and make it more difficult for new entrants to get shelf space. Indeed, this is the only practice for which complaint counsel have sought conduct relief. [10]

It could be argued that an order restricting or preventing respondents from making shelf space recommendations would help to inject more competitive pressures into an important area of non-price competition, without intruding unnecessarily into respondents' day-to-day business judgments. On the other hand, this type of activity is undoubtedly normal commercial behavior that is engaged in by many other food manufacturers, although it is not clear whether the nature and pattern of recommendations in the cereal industry are followed in other markets.

<sup>8</sup> Allegations of this nature have been made in several recent cases involving the communications and computer industries. *Northeastern Tel. Co. v. American Tel. & Tel. Co.*, 497 F. Supp. 230, 244 (D. Conn. 1980), *rev'd* 651 F.2d 76, 94-95 (2d Cir. 1981); *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 285 (2d Cir. 1979), *cert. denied*, 444 U.S. 1093 (1980); *Cal. Computer Products v. I.B.M. Corp.*, 613 F.2d 727, 744 (9th Cir. 1979); *Transamerica Computer Co., Inc. v. I.B.M. Corp.*, 481 F. Supp. 965, 1006-08 (N.D. Cal. 1979).

However, regardless of whether a workable remedy could be crafted on this subject, it is questionable whether the issue is all that important from a remedial standpoint. Dr. Schmalensee, one of complaint counsel's expert witnesses in the case, expressed the view in a separate article that shelf space plans were probably not powerful deterrant devices. Schmalensee, "Entry Deterrence in the Ready-to-Eat Breakfast Cereal Industry," 9 Bell J. Econ. 305, 307, n. 4 (1978).

A third area for possible relief involves the exchange of recent advertising expenditure data among respondents through the vehicle of a third party reporting service. It is not entirely clear whether this particular practice, specifically with respect to the accuracy and currency of the data exchanged, is unique to the cereal industry or occurs frequently in other industries. While this exchange makes it easier to monitor the actions of competitors it may be less sensitive than an exchange of price information, since the quantity of advertising expenditures does not necessarily reveal the effectiveness of those expenditures. Of course, the effectiveness of restricting this practice depends on how easily and quickly respondents could obtain similar data through other means. But, even if an order restriction would make that task substantially more difficult, it is not at all clear that it would inject a very significant destabilizing force into the market. To be sure, advertising is a major factor in respondents' non-price competition, but inducing more rivalry in this area is not necessarily calculated to produce similar spin-off effects in the pricing of RTE cereals.

Another candidate for reform is respondents' fairly consistent refusal to supply private brand cereals to retailers. While increased private brand competition could bring about more price competition, an order requiring respondents to supply such product is fraught with all kinds of problems, and could easily lead to a highly intrusive regulatory-type order. [11]

Finally, with respect to other allegedly anticompetitive conduct, such as respondents' refusal to offer trade deals or other off-list discounts, it is quite clear that the Commission cannot mandate respondents to compete. Such behavior, if it does not involve collusion, represents the kind of passive noncompetitive behavior noted above for which there is probably no practical enforcement remedy.

Thus, a review of possible avenues for conduct relief suggests that, assuming a Section 5 case can be made out, the available remedial alternatives are either intrinsically undesirable or hold little promise for producing beneficial results. To some extent, this task is made

more difficult by the fact that there is no record for determining which, if any, conduct restrictions would be useful, since the case from the outset focused almost exclusively on structural remedies. Nevertheless, despite this limitation, I am inclined to agree with complaint counsel that if any relief were suitable in this case, it should probably be structural in nature. However, for the reasons discussed previously, I am firmly opposed to seeking dissolution in a case of this kind without collusion, or possibly predation, as a legal predicate. While we might desire a better mix of price and non-price competition in the RTE cereal industry, the potential costs associated with a divestiture order, not to mention the difficulty in getting a court to approve such an exercise of our remedial discretion, lead me to reject this approach. I am also simply not persuaded that the class of cases reflected here is sufficiently large to warrant pursuing this kind of complicated, time-consuming remedial avenue. Even if this is the one case in a thousand that might justify such an approach, I do not feel that we ought to apply our Section 5 powers in this way, for what would be an essentially one-time, *ad hoc* law enforcement initiative.

Accordingly, it is my belief that the Commission should not pursue this case further.

#### DISSENTING STATEMENT OF COMMISSIONER PERTSCHUK

The Commission today takes an unprecedented step in refusing to hear the appeal of this matter. This decision raises serious implications for the integrity and propriety of Commission adjudicatory procedures. The complaint in this matter was issued in 1972 and it has taken nine years to complete pretrial procedures and the trial itself. The case raises difficult and unanswered legal questions as well as vigorously disputed factual controversies. Legal conclusions about the allegations in the complaint would have important ramifications for the applicability of the antitrust laws to concentrated industries which do not operate competitively. Thus, the case is precisely the kind of matter that warrants full-scale review by a responsible Commission, charged by Congress with adjudicatory determinations. I cite no less an authority than the Commission itself: "In this as in any other case, . . . it is the agency's function, not the Examiner's, to make the findings of fact and select the ultimate decision, and where there is substantial evidence supporting each result it is the agency's choice that governs."<sup>1</sup>

<sup>1</sup> Order Denying Motion for Dismissal of Complaint Counsel's Appeal and for Adoption of Initial Decision, Docket No. 8883 (Nov. 3, 1981), citing *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 853 (D.C.Cir. 1970).

Yet the Commission has precipitously determined that it will not grant full-scale review of this matter, apparently on the grounds that it would be a waste of resources. The resources at stake apparently are the costs of a round of briefs concerning the administrative law judge's opinion, an oral argument, and the preparation of an opinion—not trivial, I grant, but not significant compared to the length, complexity and importance of this matter.

It cannot be ignored that this case has been controversial and that Congress has expressed concern about it. The respondents have attempted to make much of the fact that the Commission, at one point, offered a contract to the original trial judge to continue the matter after his intended retirement. In my view, this step by the Commission raised no significant question of impropriety, and the respondent's zeal in pursuing it has essentially been an aggressive legal and political maneuver. Respondents have also engaged in [2] intensive lobbying efforts in Congress to accomplish the premature demise of this case. I do not question their right to pursue either of these tactics. I do question, however, the propriety of Congressional intervention in any matter before it has run its course of proper adjudicatory procedures. I also question whether Congress has ever been furnished with a complete analysis of this difficult case and the legal arguments that have been raised in it.

I view the prior Congressional intervention in this matter, the vigorous efforts by respondents to heighten controversy about it, and the spurious characterizations of the Commission's effort to carry out its administrative responsibilities by offering a contract to the original trial judge as an unfortunate backdrop to this decision by the Commission to stop review of this matter in midstream.

This case was argued on the basis of two theories—1) a conspiracy based on traditional Sherman Act Section 1 principles and 2) a theory of interdependent behavior in a highly structured industry with poor competitive performance and where industry members have engaged in exclusionary conduct, what has come to be known in somewhat misleading shorthand as a "shared monopoly." If the case had been appealed, I would, of course, have carefully considered the conspiracy argument, which if proved, would certainly violate long-held principles of the antitrust laws. Based upon my tentative review, I am inclined to believe a finding of a traditional conspiracy could not fairly serve as a basis of liability.<sup>2</sup> I emphasize this conclusion is only tentative, and I would have wished to have heard further arguments by the parties on this issue.

<sup>2</sup> I base this conclusion on my interpretation of the complaint, which does not appear to allege a conspiracy, rather than the evidentiary record, which may well show a conspiracy existed.

As to the shared monopoly theory as initially pled, it is important to note what the theory is and what it is not. It is not an allegation of an agreement, either an expressed or implied conspiracy.<sup>3</sup> Consequently, it does [3]not fit the conventional analysis applied in Sherman Act Section 1-type matters. Nor is it an allegation of practices by individual companies which, under the circumstances of the industry, facilitate uniform pricing or other anticompetitive behavior. Finally, it is not an allegation that each firm engaged in exclusionary practices which independently violate Section 5 by unfairly raising barriers to new entry or driving out equally efficient competitors. Although there are aspects of these theories which were pled in the complaint, it is more appropriate to view the shared monopoly theory as standing apart from them and not requiring the same elements necessary to show a violation under these other theories. It is important to note, however, that these theories, which like the shared monopoly theory, are attempts to define illegal behavior in oligopolistic markets, are important to effective antitrust enforcement and are not undermined in any way by today's action by the Commission.

The shared monopoly theory, as reflected in the Commission's complaint in this matter, was predicated upon an allegation of high concentration, as evidenced by a three-firm concentration exceeding 80%; poor competitive performance, as measured, for example, by sustained high profits and the absence of price competition; and high barriers to entry caused by exclusionary conduct of industry members,<sup>4</sup> as evidenced, for example, by the absence of significant new entry since 1950. Thus, the theory of the case does not "condemn the [industry] structure itself" as the Bureau Director's statement of December 11 supposes.

Such a theory is supported by scholarly commentary, including that of Professors Areeda and Turner,<sup>5</sup> Professor [4]Sullivan<sup>6</sup> and others. Thus, it is not the case that "the theory has . . . utterly failed to enter the mainstream of economic thought," as the respondents claim. Rather, this case represents a serious, carefully thought out

<sup>3</sup> A charge of conspiracy to monopolize could, of course, be based upon tacit collusion where joint action stems from assent by action rather than words. *Interstate Circuit v. U.S.*, 306 U.S. 208 (1939). Consequently, it would not have been unreasonable to plead a conspiracy based on the facts alleged in the complaint, though, as stated earlier, I do not believe the Commission did so.

<sup>4</sup> Exclusionary practices need not in themselves be independently unlawful or predatory to constitute acts of monopolization. See, e.g., *U.S. v. Griffith*, 334 U.S. 100, 105 (1948); *American Tobacco Co. v. U.S.*, 328 U.S. 781, 809, 814 (1946). Thus, each of the respondents need not have engaged in unfair predation under Section 5 or an attempt to monopolize under Section 2 of the Sherman Act in order to have been found to have engaged in monopolizing. We do not deal here with an allegation that there has been monopoly power shared by three firms without monopolizing conduct.

<sup>5</sup> See 3 P. Areeda and D. Turner, *Antitrust Law* 359-390 (1978).

<sup>6</sup> See L. Sullivan, *Antitrust* 361-366 (1977).

attempt by a no-nonsense Republican-led Commission in 1972 to deal with the problem of a tight oligopoly and a poorly performing industry.

Today, the Commission turns its back on this attempt, not wishing to deal with the difficult but necessary task of spelling out whether and under what circumstances the antitrust laws reach this problem. Such a step by the Commission is a significant one, with major ramifications for government antitrust policy. We should make no mistake about it: the problem of high concentration—industries operated by a few giant companies with poor competitive performance, as indicated by the absence of meaningful price competition and the absence of significant entry of new competitors over a long period—is not going to disappear from our economy in the coming decades. Our economy is now made up of a number of highly concentrated industries without meaningful price competition and, if the merger laws are not to be enforced vigorously, this situation will become more frequent, not less.

I for one believe that Section 5 of the Federal Trade Commission Act does reach a situation where an industry is highly concentrated; the performance of the industry as measured by profit levels, lack of price competition or other factors, is poor; effective barriers to entry are created by exclusionary conduct on the part of the firms; and a government-ordered remedy can be shown to be likely to improve competition. I also believe that it is possible for this Commission and for the courts to identify, after careful study, which industries are appropriate for restructuring in order to deal with the problem, and which industries are not.<sup>7</sup> But I also conclude that the prospect for some future Commission effectively to apply this theory is highly unlikely. It is not that there will not be farsighted and courageous Commissions in the future, nor certainly that there will be an absence of careful economic analysis capable of identifying [5] industries which should be addressed; nor do I view this decision by the Commission today in any way as a legal precedent which deserves to be followed by a future Commission or by the courts. Rather, I view today's decision as confirmation of the political inability of a Commission to see such a case through to the end.

As our political system provides, the Commission reflects, to a large extent, the prevailing political attitudes and the economic philosophy of the current administration. And, quite properly, future Commissions will reflect the then-prevailing political philosophy. Unfortunately, an attempt by the inherently lengthy process of

<sup>7</sup> In some situations, a conduct-oriented remedy alone may be adequate, e.g., by prohibiting certain exclusionary practices.

litigation to deal with the oligopolistic problem I have described requires a political consensus that an independent commission is legitimate and competent to carry out the task, and a political environment which gives it the room and time to carry it out. Today's decision seems to me to tell us that such a consensus is unlikely. Therefore, I believe strongly that Congress, not this one perhaps, but some future one, should brace itself for the task of spelling out in careful, responsible legislation what government's role is in dealing with the problem of oligopoly. And I emphasize again that it is a problem which is destined to become more, rather than less, significant for our society.

STATEMENT OF COMMISSIONER PATRICIA P. BAILEY

This controversial case was formally launched on January 24, 1972, when Chairman Miles Kirkpatrick and Commissioners Rand Dixon and Mary Jones voted to issue the Commission's complaint.<sup>1</sup> Commissioners David Dennison and Everette MacIntyre opposed this action, and filed dissenting statements. Commissioner MacIntyre was prescient with regard to the ultimate procedural course of this matter, predicting "much litigation and little reform," and further suggesting that the resolution of certain "untried issues" could take "perhaps years". A Congressman from Michigan was prescient about the political course of this matter: the then-Representative from Battle Creek denounced the issuance of the complaint almost immediately.

The Commission's complaint (paragraph 9) charged three species of violations of the FTC Act: First, that the respondents had individually and collectively maintained a "highly concentrated, noncompetitive market structure." Second, that the respondents had individually and collectively shared and exercised monopoly power. Third, that the respondents "erected, maintained, and raised" barriers to entry of new competition through unfair methods of competition. The methods of competition in question representing the exercise of monopoly power, as detailed in paragraphs six and seven of the complaint, included: 1) brand proliferation through differentiating similar products and promoting trademarks through intensive advertising, 2) misleading advertising of the value of cereals in regard to childrens' health, weight control and athletic prowess, 3) control of shelf space, 4) acquisition of competitors, 5) mutual restraint [2]in challenging price increases, 6) restricted use

<sup>1</sup> This was pursuant to the Commission's old Part II ("opportunity for settlement") Rules. The Part III adjudicative complaint issued in April 1972.

of trade deals or trade-directed promotion, and 7) limitations on the use of "consumer directed promotions, such as coupons, cents off deals, and premiums." According to paragraph 8, as a result of all this, high barriers to entry successfully forestalled new competition; the introduction of new products was curbed; cereal prices and profits were higher than they would be in a competitive market.

Much has been made, since the inception of this case, over the fact that it represents a test of the so-called "shared monopoly" theory. The complaint is subject to being so construed, depending on one's interpretation of paragraph 9(b).<sup>2</sup> It is certainly true that press reports and even academic journals have from the first characterized this case in terms of a shared monopoly theory.<sup>3</sup> The respondents in this matter have sought for years irrevocably to pin this badge on complaint counsel, who, for their part, have raced across the legal plain seeking to avoid the shared monopoly stigma, trying first the conspiracy gambit, falling at last across the finish line with a paper that mentions only "tacit collusion", and not shared monopoly even once. The Director of the Bureau of Competition believes that [3]only a shared monopoly theory was ever at issue in the case. The Administrative Law Judge details the history of the theory of the case, beginning with early pretrial statements by complaint counsel that conspiracy was specifically not a part of the complaint. Later, the original Law Judge assigned to this matter permitted complaint counsel—over strenuous objections by respondents—to put into the record evidence of tacit collusion.<sup>4</sup> Judge Berman, though believing collusion not to have been pled as a part of this case, nonetheless based his ruling on consideration of *both* collusion *and* shared monopoly theories.

Judge Berman has dismissed this case for failure of proof on either of those theories.

The Director of the Bureau of Competition withdrew the earlier notice of intent to appeal filed in this matter because he believes a shared monopoly theory "is not consistent with the public interest," is "an unwarranted expansion of the law," and has the prospect of punishing success among the competing cereal producers. Withdrawal of an appeal of a Federal Trade Commission complaint by those

<sup>2</sup> I objected, joined by Commissioner Pertschuk, to the singular characterization of this case as a shared monopoly matter in connection with the issuance of the press release dated December 18, 1981, announcing our 3-1 vote to solicit staff views on the propriety of the appeal of this matter. We felt that the characterization of the case was one of the main issues before us; but, in any event, the press release was issued notwithstanding our expressed concerns.

<sup>3</sup> "The Cereal Case: Opening Shots in FTC War on 'structural' Shared-Monopoly or Attack on 'marketing' irregularities?" 5 Antitrust Law and Econ.Rev. 71 (1971); "Oligopolies, Cereals, and Section Five of the Federal Trade Commission Act," 61 Geo.L.J. 1145 (1973).

<sup>4</sup> Orders of Judge Hinkes dated February 24, 1974, March 12, 1975, and August 20, 1976.

charged formally with its prosecution is virtually without precedent. The fact is that this is the Commission's—and not the staff's—complaint. The Bureau's involvement in this matter is in the nature of a stewardship, and the Bureau itself is but an administrative creation of the Commission to facilitate the accomplishment of tasks delegated to it by the Commission, including the litigation of Commission complaints. [4]

Nonetheless, the issue has been joined, and I do not fault the Director of the Bureau for candidly stating his views of which theories, in his opinion, the Commission should and should not be litigating.

My concern, expressed in our Order of December 18, 1981, following the Commission's receipt of the Bureau Director's views of December 11, 1981, was only that our Order of December 3, 1981, directing the submission of the views of complaint counsel be complied with. That has now belatedly been accomplished. As already noted, the attorneys and economist who have handled this matter for the past decade do not describe the case in terms of shared monopoly but in terms of tacit collusion, violative of the standards set out in *American Tobacco Co. v. United States*, 328 U.S. 781 (1946). "In the most traditional antitrust sense, the three respondents have tacitly colluded and cooperated to maintain and exercise monopoly power—'power over price' and 'power to exclude' additional competitors." According to the staff, "The case does not challenge the industry's structure itself," (Staff at 11), but shows a pattern of sophisticated conduct that has raised barriers to entry for new competition, and facilitated higher than competitive price levels.

I am aware of that body of commentary that believes the *American Tobacco* case adds to the law of monopolization by extending the analysis into an oligopoly setting. Professor W.H. Nicholls, stated as long ago as 1949:

The *Tobacco* case is clearly a legal milestone in the social control of oligopoly. By permitting the inference of illegal conspiracy from detailed similarity of behavior . . . the [5]courts have at last brought oligopolistic industries within the reach of successful prosecution under the antitrust laws.<sup>5</sup>

He went on to say that the inference of conspiracy in the case was based on the assumption "that a few dominant firms will perhaps independently and purely as a matter of self interest, evolve non-aggressive patterns of behavior . . ." Professor A.D. Neale disagrees with this interpretation of the case. In response to Nicholls he stated:

<sup>5</sup> W. Nicholls, "The Tobacco Case of 1946," 39 *American Economic Review*, 296 (1949), cited as A.D. Neale, *The Antitrust Laws of The U.S.A.* 165 (2d Ed., 1970).

(He (Nicholls) is attributing to the court and the jury more economics than they would own: what the jury found and the Court confirmed was precisely that the conduct of the firms could not be accounted independent action. Rightly or wrongly, the Kentucky jury felt able to infer a true 'meeting of the minds' from the evidence, and the case really adds nothing new to the law of conspiracy. This is confirmed by Mr. Justice Burton's summary of this aspect of the case: 'The essential combination or conspiracy in violation of the Sherman Act may be found in a course of dealings or other circumstances as well as in any exchange of words . . . where the circumstances are such as to warrant a jury in finding that the conspirators had a unity of purpose or a common design and understanding, or a meeting of the minds in an unlawful agreement, the conclusion that a conspiracy is established is justified.'<sup>6</sup>

Despite complaint counsel's use of the terminology "tacit collusion," I believe such an argument amounts to allegation of a conspiracy, even under complaint counsel's cited cases. [6]

I am also constrained to agree with Judge Berman that a conspiracy charge was not a part of the Commission's complaint and that complaint counsel so stated in pretrial filings made on May 18 and 22 and June 19, 1972, and in pretrial statements made by complaint counsel Robert Liedquist on June 5 and 8 and August 10, 1972. The absence of a conspiracy charge was also asserted at least twice in federal court proceedings.<sup>7</sup> The admission of evidence on conspiracy made by the original ALJ, Judge Hinkes, amounted to a transgression of Commission Rule 3.15(a)(1) which prescribes the correct procedures for amendments to complaints. Nor does Rule 3.15(a)(2), providing for the admission of evidence "reasonably within the scope of the original complaint or notice of hearing," provide solace, since that rule requires both sides to acquiesce, and respondents have fought the notion of a collusion theory from the inception of these proceedings.

Viewing this case as a shared monopoly matter does not trouble me. Professors Areeda and Turner have postulated that

If . . . Sherman Act Section 2 permits a government action in equity against a substantial and persistent single firm monopoly that has not behaved improperly, it also permits a similar action against the substantial and persistent shared monopoly. As compared with single-firm monopoly, however, there are important additional difficulties in identifying cases suitable for intervention, identifying the proper defendants, formulating appropriate remedies, and supporting judicial innovation.<sup>8</sup>

The authors go on to state that evidence of shared monopoly power

<sup>6</sup> Neale, *Op. Cit.* 166. Violations of the Sherman Act are also violations of Section 5 of the FTC Act, *FTC v. Raladam Co.*, 283 U.S. 643 (1931).

<sup>7</sup> Contemporary reports of the Commission's action took special note of the absence of a conspiracy charge. Note, "Oligopolies, Cereals, and Section Five of the Federal Trade Commission Act," 61 *Geo.L.J.* 1145, 1149 (1973).

<sup>8</sup> III Areeda and Turner, *Antitrust Law* 360 (1978).

should be coupled with evidence of "exclusionary conduct [7]having a significant causal relation to shared monopoly power."<sup>9</sup> For the purposes of my analysis, I am willing to assume that the exclusionary conduct alleged by complaint counsel has occurred, and that the respondents, three of which control 79% of cereal sales, share monopoly power in this \$740 million market.<sup>10</sup>

The question then would be one of remedy. Indeed, the paramount difficulty with this case has always been the question of remedy. For whatever it is that Kellogg and the other respondents may have done, the proposed solution—to carve new cereal companies from the hides of existing ones and to force the licensing of successful trade names to the newly created competitors—is both draconian and manifestly uncertain to achieve the relief complaint counsel postulates that it will.

Areeda and Turner have stated:

Quite apart from statutory limitations, even a czar would consider restructuring only where it is likely to improve net economic performance substantially; and we say 'substantially' to take account of the costs of the process, including the risk of erroneous judgments.<sup>11</sup>

Thus, assuming that the appropriate substantial and noncompetitive market structure required for a shared monopoly is present, the key issue becomes whether relief is available significantly to improve economic performance without sacrificing such economically worthy goals as substantial economies of scale.<sup>12</sup> [8]

The difficulties possibly attendant to divestiture relief make it less than clear that improved industry performance is the inevitable consequence. Respondents and intervenors (the grain millers union) view the industry restructuring proposal as "an unprecedented and unworkable experiment in industry reorganization" (Respondents at 5). Dismantling of existing cereal plants, including those that now make other non-cereal products as well, may cause substantial interruptions or reductions in production. Existing labor-management harmony may be disrupted. Trademark licensing may result in excess capacity and stifle product development, and disrupt economies of scale in production, distribution and sales. Of course, all of

<sup>9</sup> *Id.*

<sup>10</sup> I recognize that the ALJ did not find this industry to be characterized by monopoly profits. I also recognize complaint counsel's strong assertion that the ALJ's methodology was faulty on this score.

<sup>11</sup> *Id.*, 372.

<sup>12</sup> For an interesting discussion of the primacy of economies of scale in oligopoly antitrust analysis, see Sherman and Tollison, "Public Policy Toward Oligopoly: Dissolution and Scale Economies," 4 *Antitrust Law and Econ. Rev.* 77 (1971). The evidence in this record on economies of scale is in conflict. Complaint counsel believe that entry into this market by a single cereal brand line is impractical, and that industry participation at from 3.5% to 5% is necessary to achieve firm economies of scale. This dispute bears both on the issue of barriers to entry as well as the issue of relief. Only an appeal of this matter would allow the Commission to assess the conflicting evidence.

this may be the conjecture of self-serving private interests, but the complex dismantling of a long-existing industry is sufficiently clouded with doubts to give one pause. Indeed, even complaint counsel's own expert has stated that the remedy proposed may "for reasons unforeseen bring about the opposite result or may impose debilitating losses upon the big three."

Moreover, it is also a concern of mine that an administrative agency, operating under a tightly supervised legislative mandate, undertake industry restructuring under a theory that clearly represents an extension of Sherman Act analysis. While Areeda and Turner believe that a viable shared monopoly theory exists, and that it can—even now—be entrusted to the government antitrust authorities, they acknowledge the difficulties of such a case. Concentration ratios and market performance tests, determination of markets appropriate for attack, and whether [9]there should be an assessment of substantial scale economies proved by an accused oligopolist, all present merely the threshold questions in approaching a shared monopoly prosecution.

Although not necessarily insuperable, these difficulties may suggest that the courts should refrain from taking so grave and novel a step without a new mandate from Congress. The issue is a serious one.<sup>13</sup>

I come ultimately to the view that industry restructuring, such as is proposed here, is essentially a legislative concern, and as an agency that fairly can be characterized as an arm of the Congress, we should not undertake to restructure an industry under Section 5 of the FTC Act without a clear supportive signal from the Congress. In this case, the signals are, for the present, quite to the contrary—as they were not so apparently in 1972 when this complaint issued. The Federal Trade Commission has from time to time commented favorably on various legislative proposals amounting to industrial restructuring.<sup>14</sup> None of these proposals has taken root as a preferred route for industrial market reorganization. I do believe that if the Congress were to endorse a shared monopoly approach to restructuring an oligopoly, this agency has the power to effect this sort of [10]change under a viable and respectable theory.<sup>15</sup> But the use of the power of divestiture or divorcement under Section 5 of the

<sup>13</sup> III Areeda and Turner, 380. Professor Turner's own views seem to favor the legislative approach; see: Turner, "The Scope of Antitrust and Other Economic Regulatory Policies," 82 Har. L. Rev. 1209 (1969).

<sup>14</sup> See for example: Statement of Federal Trade Commission before the National Commission for the Review of Antitrust Laws and Procedures, urging legislation affecting antitrust action against some monopolies, February 22, 1978.

<sup>15</sup> For a complete summary of the FTC view on this point, see: Testimony of Commissioner Robert Pitofsky on the Heflin Amendment before the Senate Commerce Committee, November 30, 1979. "Certainly the Commission has been restrained and circumspect in the extreme in imposing structural relief. We have been able to find only six cases since 1963 where structural relief was sought."

FTC Act is the ultimate exercise in administrative authority. It should be used only to achieve a Congressionally endorsed result, or at least not to defy a clearly expressed congressional animus, as exists here. I note, too, that even candidates of both major political parties in the last national election denounced this case as ill-advised and contrary to the public interest.

Why all this concern has risen to the level that it has is difficult to explain, in light of the fact that the Commission is only mid-stream in this case, and both Commission and court review—not to mention potential congressional action—lie ahead to safeguard against any precipitous or unwarranted action in this matter. The issue here is larger than the *Kellogg* case, to be sure. Professor Joseph Brodley reflected in some depth on the practical, as well as the philosophical, problem of exercising prosecutorial discretion to its ultimate end in cases of this sort:

In law, as in politics, public policy must often be the art of the possible. For this, as well as for other reasons, I put to one side the proposal that existing concentrated oligopoly firms be broken up . . . (A)ny large or even moderate scale attack on existing industrial concentration would run into congressional stormwaters of imposing magnitude. [11]

In part, this may simply reflect an ambivalence of attitude in United States antitrust laws. The British writer, Neale, has noted the tendency of Americans "to take a romantic view of the achievements and efficiency of large industrial organizations even while they take a suspicious view of their power." (citation omitted) Such an attitude has made the remedy of divestiture rare even in Sherman Act cases.

Perhaps, more basically, in a nation so thoroughly pragmatic as this one, there is an understandable reluctance to push an economic theory, however well founded, to the extreme conclusion of causing drastic rearrangements of large sections of American industry. . . .<sup>16</sup>

The paradox we are left with is that while there may be a legitimate concern about the anticompetitive effects of the exercise of oligopoly power, it is rarely true that these concerns will mandate an administrative agency decision to restructure an industry, short of a legislative warrant to that effect. Therefore, I will vote that this appeal be terminated, not for the reasons relied upon by the Administrative Law Judge, but because the promulgation of relief by this agency will not, in any eventuality, conceivably lead to a restructuring of the cereal firms.

As may be evident, I do not intend the Initial Decision in this matter to become the final decision of the Commission. The Commission's Rules provide that if an appeal of an Initial Decision is

<sup>16</sup> Brodley, "Oligopoly Power Under the Sherman and Clayton Acts - From Oligopoly Theory to Legal Policy," 19 Stan. L. Rev. 285, 344-45 (1967).

not forthcoming, the Initial Decision becomes the decision of the Commission.<sup>17</sup> According to complaint counsel, [12]the Initial Decision is riddled throughout with major procedural errors, and does not fairly give weight to certain of the evidence. I do not know whether this is true or not, and since I could not resolve these conflicts except through the process of appeal, it is my intention that the Initial Decision have no precedential or even persuasive authority for any proposition whatsoever. Thus, I will vote to docket the Initial Decision for the sole purpose of vacating it in its entirety and substituting for it a simple order of dismissal.

A few final words:

The fortitude and determination of those attorneys and economists who were charged so long ago by the Commission to prosecute this matter is a source of pride and admiration. No more difficult matter ever was considered to this point by this institution. No matter has been subjected to more criticism. No more difficult duty has been undertaken without sufficient thanks or recompense. In the face of everything, the staff of this agency has done the job it was ordered to do, and acquitted itself ably and with honor. The fact that now the Commission abdicates its commitment to see this matter through is a responsibility that rests uniquely upon our shoulders and not upon theirs.

I very specifically disassociate myself from what the Chairman had to say about this matter in his statement of December 18, 1981. Neither do I join in Commissioner Clanton's statement of views on this matter nor in Commissioner Pertschuk's [13]clarion, but quixotic, call to battle.<sup>18</sup> I speak, only for myself, and I willingly take public and lasting responsibility for what I do today.

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<sup>17</sup> Rule 3.51(a).

<sup>18</sup> Commissioner Pertschuk's participation in this matter has been challenged; any legal ability to advance the appeal of this matter pursuant to Reorganization Plan No. 4 of 1961 would surely be challenged—adding only and inevitably to the record of delay of this case, diverting for additional years the Commission's ability to evaluate this case on the merits.

IN THE MATTER OF  
RENUZIT HOME PRODUCTS COMPANY

CONSENT ORDER, ETC., IN REGARD TO ALLEGED VIOLATION OF  
SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

*Docket C-3081. Complaint, Jan. 20, 1982—Decision, Jan. 20, 1982*

This consent order requires, among other things, a Philadelphia, Pa. manufacturer and distributor of transmission and hydraulic fluids and motor oils to cease making any representations concerning the API Service Classification, SAE Viscosity or any performance or quality characteristic of its motor oils unless the company possesses documentation supporting those representations. Respondent is further prohibited from misrepresenting the purpose, content, or conclusions of any test or survey, and required to furnish all personnel engaged in advertising, quality control or policy-making with a copy of the order.

*Appearances*

For the Commission: *Michael Dershowitz and Lewis Morris.*

For the respondent: *Pro se.*

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that Renuzit Home Products Co., a corporation, hereinafter sometimes referred to as respondent, has violated the provisions of said Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

PARAGRAPH 1. Respondent Renuzit Home Products Co. is a corporation organized, existing and doing business under and by virtue of the laws of the State of Pennsylvania, with its office and principal place of business located at 3rd and Berks Streets, Philadelphia, Pennsylvania.

PAR. 2. Respondent is now, and for some time last past has been, engaged in the manufacturing, offering for sale, sale and distribution of motor oils, transmission fluids, and hydraulic fluids to retailers for sale to the public.

PAR. 3. In the course and conduct of its business, respondent ships its products to wholesale purchasers throughout the Mid-Atlantic region. Respondent prepares promotional and labeling

materials for its product in Philadelphia, Pennsylvania and disseminates these materials throughout the Mid-Atlantic region. Respondent, therefore, maintains a substantial course of business, including the acts and practices as hereinafter set forth, which are in or affect commerce, as "commerce" is defined in the Federal Trade Commission Act.

PAR. 4. In the course and conduct of its business, and in order to induce the sale of its products to the public, respondent has disseminated labels for use on its motor oils.

Typical and illustrative of the statements and representations included on its labels, but not all-inclusive thereof, are the following:

API Services SE-CC-MS Meets API Specifications as shown on lid.

\* \* \* \* \*

SAE 10W-20W-30

PAR. 5. At the time respondent made the statements and representations alleged above, it did not possess and rely upon a reasonable basis for such statements and representations. Therefore, said statements and representations were unfair, deceptive, or misleading.

PAR. 6. By and through the use of the aforementioned statements and representations, respondent has represented directly or by implication, that it had a reasonable basis for making, at the time they were made, the statements and representations alleged in Paragraph Four. In truth and in fact, respondent had no reasonable basis for such statements and representations. Therefore, said statements and representations were deceptive, misleading, or unfair.

PAR. 7. In the course and conduct of its business, and at all times mentioned herein, respondent as been, and now is, in substantial competition in or affecting commerce with corporations, firms and individuals engaged in the wholesale sale of motor oils, transmission fluids, and hydraulic fluids.

PAR. 8. The use by respondent of the aforesaid deceptive, misleading, or unfair statements and representations and their dissemination has had the capacity and tendency to mislead members of the public into the erroneous and mistaken belief that said statements and representations were true and complete, and into the purchase of substantial quantities of respondent's motor oils by reason of said erroneous and mistaken belief.

PAR. 9. The acts and practices of respondent, as herein alleged, including the dissemination of deceptive, misleading, or unfair

statements and representations, were all to the prejudice and injury of the public and of respondent's competitors and constituted, and constitute, unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce in violation of Section 5 of the Federal Trade Commission Act.

#### DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of complaint which the Bureau of Consumer Protection proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Federal Trade Commission Act and;

The respondent and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondent had violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent Renuzit Home Products Co. is a corporation organized, existing and doing business under and by virtue of the laws of the State of Pennsylvania, with its office and principal place of business located at 3rd and Berks Streets, in the City of Philadelphia, State of Pennsylvania.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

## ORDER

## PART I

*It is ordered,* That respondent Renuzit Home Products Co., a corporation, its successors and assigns, and its officers, and respondent's agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in connection with the manufacture, advertising, offering for sale, sale or distribution of motor oils in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

- a. representing, directly or by implication, that its motor oils are of any American Petroleum Institute (API) Service Classification; or
- b. representing, directly or by implication, that its motor oils are of any Society of Automotive Engineers (SAE) Viscosity; or
- c. representing, directly or by implication, any other performance or quality characteristics of its motor oils;

unless each representation is true, and unless at the time of making each such representation, respondent possesses and relies upon competent and reliable scientific tests which substantiate each such representation.

For purposes of substantiating representations of the API Service Classification of any motor oil, respondent shall obtain for each such product passing scores on the appropriate engine sequence tests, as described in the then current SAE Technical Report J183, "Engine Oil Performance and Engine Service Classification", or any succeeding document which has the same force and effect as SAE Technical Report J183. In lieu of conducting engine sequence tests on motor oils of its own formulation, respondent may use a motor oil blend formula developed by another manufacturer, if a motor oil blended to that formula has been tested in a competent and reliable manner by the manufacturer that developed the motor oil blend formula or some other reliable testing facility in the manner set out above and has received passing scores, and respondent possesses true and complete documentation to that effect at the time it makes any representation of the API Service Classification of its own product. The initial testing to determine the API Service Classification of a motor oil manufactured according to any formula used by respondent shall be supplemented by respondent through periodic testing of batches, runs or blending tank lots of its motor oils. The samples to be tested shall be selected according to a predetermined protocol

consistent with proper quality control and shall be subjected to tests which indicate the presence and quantity of additives necessary to produce motor oil which conforms to the API Service Classification claimed for respondent's product. Respondent may choose any valid scientific method for the supplemental tests and the sampling protocols as long as the methods and protocols have been approved by the Commission staff.

For purposes of substantiating SAE Viscosity, each motor oil manufactured by respondent shall be tested in accordance with the procedures set out in the then current SAE Technical Report J300d, "Engine Oil Viscosity Classification" or any succeeding document which has the same force and effect as SAE Technical Report J300d, and must receive test scores within the limits described therein.

Each separate batch, run or blending tank lot of motor oil manufactured by respondent shall be tested for SAE Viscosity according to a predetermined protocol consistent with proper quality control and passing scores obtained before respondent makes any representations of the SAE Viscosity of its motor oil products. The sampling protocol to be used must first be approved by the Commission staff.

Attached to this Order and incorporated by reference is a protocol for the supplemental sampling and testing of respondent's motor oils. This protocol has been approved by Commission staff for use by respondent.

#### PART II

*It is further ordered,* That respondent Renuzit Home Products Co., a corporation, its successors and assigns, and its officers, and respondent's agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in connection with the manufacture, advertising, offering for sale, sale or distribution of motor oils in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from misrepresenting in any manner the purpose, content, or conclusions of any test or survey pertaining to motor oils.

#### PART III

*It is further ordered,* That respondent Renuzit Home Products Co., a corporation, its successors and assigns, and its officers, and respondent's agents, representatives and employees, directly or through any corporation, subsidiary, division or other device in connection with the manufacture, advertising, offering for sale, sale,

or distribution of motor oils in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from failing to maintain accurately, documentation that substantiates any and all of respondent's statements or representations on labels or other promotional materials disseminated by respondent or by any officer, representative, agent, employee, subsidiary or division of the respondent, concerning the API Service Classification, SAE Viscosity or any other performance or quality characteristic of motor oils. Such documentation shall be retained by respondent for a period of three years from the date such labels or other promotional materials were last disseminated, and copies thereof shall be furnished to the Commission staff upon reasonable notice.

#### PART IV

*It is further ordered,* That respondent distribute a copy of this order to each of its operating divisions, and to all present or future personnel, agents or representatives having advertising, quality control or corporate policy responsibilities with respect to the subject matter of this order and that respondent secure from each such person a signed statement acknowledging receipt of said order.

#### PART V

*It is further ordered,* That respondent notify the Commission at least thirty (30) days prior to any proposed change in the respondent, such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change in the corporation which may affect compliance obligations arising out of this order.

#### PART VI

*It is further ordered,* That respondent shall, within sixty (60) days after service upon it of this order, and also one (1) year thereafter, file with the Commission a report, in writing, setting forth in detail the manner and form in which it has complied with this order.

## Renuzit Home Products Company Quality Control Protocol

[Date]

(Supersedes Any Previous Protocols)

## I. DOCUMENTATION

A. The purposes for documenting the production of motor oil are to ensure product quality and to allow the identification of the cause of any variation from expected product quality.

B. All blending shall conform to the formulation set out in [name of additive package manufacturer] specification [identification name or number of specification] ([date of specification]). A motor oil blended to this specification received passing scores in engine sequence tests (SAE Technical Report J183) [test identification number] on [date of test score report] by [name and address of testing laboratory].

C. Each blend run shall be documented on a Blend Request Form. Each Blend Request Form shall contain the following information for each blend run:

1. blend run identification number;
2. blending tank number;
3. blending date;
4. time blending began;
5. time blending was completed;
6. total agitation time;
7. SAE grade;
8. API service classification;
9. blend stock storage tank identification number, and amount by volume of each base stock used in the blend run;
10. additive storage tank identification number or other container identification, and amount by volume of each additive package, viscosity index improver or other nonbase stock component of the blend;
11. total volume of final product;
12. blend formula identification name or number;
13. blend formulation by percent volume of each component used;
14. name of the person in charge of producing the blend run;
15. name of the person taking the blend run quality control sample;
16. name of the testing laboratory to which the blend run quality control sample is submitted; and
17. quality control manager's name, approval and date of approval.
18. identification number of the holding tank the blend run is transferred to; and
19. date of transfer to the holding tank, if different from the blending date.

D. All base stock, additives, viscosity index improvers and other components shall be recorded according to the date of delivery, invoice number, manufacturer and storage tank or other container.

E. All Blend Request Forms, component invoices, lists of blend component code numbers, blend formula specifications, Daily Gallonage Tankage Reports, Production Cards, Daily Production Record, Daily Laboratory Reports, and other documents relevant to a blend run shall be segregated and retained on file for three years after the date each blend run is produced.

## II. BLEND SAMPLING

## Decision and Order

99 F.T.C.

A. Upon completion of a blend run, the blending tank shall be sampled according to the then current ASTM Standard D 270-65 "Standard Method of Sampling Petroleum and Petroleum Products", or any succeeding document that has the same force and effect. The sample should be divided into equal portions.

B. Each blend run quality control sample portion shall be tagged and identified by blend run identification number, tank number, SAE grade, API service classification, and gallonage. Upon completion of identification, one sample portion shall be taken to the laboratory for testing. The other portion shall be retained and safeguarded for one year after the date the run is blended.

## III. BLEND APPROVAL

A. Packaging of a blended product may *not* take place under any circumstances until the product has been approved by the Quality Control Manager after examination of the results of the laboratory tests on each blend run.

B. Approval of blended products shall be based on the results of the series of tests listed below. Reference is to the current version of these tests, or any succeeding document that has the same force and effect.

## 1. Multigrade oils:

## a. Grades:

SAE 10w30 API Service Classification SF-CC  
 SAE 10w40 API Service Classification SF-CC  
 SAE 10w50 API Service Classification SF-CC  
 SAE 20w50 API Service Classification SF-CC

## b. Tests Required:

Kinematic Viscosity @ 210°F	ASTM D445
Cold Cranking Simulator @ 0°F	ASTM D2602
API Gravity	ASTM D287
Color	ASTM D1500
Elemental analysis of:	
Barium, Calcium, Magnesium, Phosphorus and	
Zinc (see Appendix A for analysis procedure)	

## 2. Single-grade oils:

## a. Grades:

SAE 10 API Service Classification SF-CC  
 SAE 20 API Service Classification SF-CC  
 SAE 30 API Service Classification SF-CC  
 SAE 40 API Service Classification SF-CC

## b. Tests Required:

Kinematic Viscosity @ 100°F	ASTM D445
Kinematic Viscosity @ 210°F	ASTM D445
Viscosity Index	ASTM D2770
API Gravity	ASTM D287
Color	ASTM D1500
Elemental analysis of:	
Barium, Calcium, Magnesium, Phosphorus and	
Zinc (see Appendix A for analysis procedure)	

C. The results of the testing listed above shall be recorded by laboratory personnel on the Blend Request Form and the Daily Laboratory Report.

D. Each Blend Request Form shall be reviewed by the Quality Control Manager for *final* approval. Approval shall be based on the comparison of the test results for the blend run quality control sample to the specifications concerning viscosity set out in SAE Technical Report J300d, "Engine Oil Viscosity Classification", or any succeeding document that has the same force and effect, and data concerning additive levels supplied by [name of additive package manufacturer]. (See [blend formula specifications]).

E. Once final approval is given by the Quality Control Manager, the product shall be entered on the Daily Gallonage Tankage Report, which shall identify each blend by SAE grade, API service classification, tank number, blend run identification number and date blended.

#### IV. PACKAGING OF APPROVED BLENDED PRODUCT

The Daily Gallonage Tankage Report shall be used as a guide by the Production Manager when assigning work to the filling lines. Instructions shall be issued via the Daily Production Record, which shall identify the tank from which oil of a particular viscosity grade and API service classification shall be drawn, the size of containers to be filled, the quantity to be filled, and the date coding to be used. All filled cases of motor oil containers shall be date coded as per the Production Card.

#### V. FILLING INSPECTION OF APPROVED PRODUCT

A. It is the Filling Line Foreman's responsibility to obtain a sample directly from the filling pipe line for each product being filled. A filling sample shall be obtained within the first five minutes of the filling production run, identified by SAE grade, size and type of container being filled and the identification number of the tank the product is being drawn from, and immediately taken to the laboratory. If a large filling production run of the same product is interrupted by a rest or lunch period, another filling sample shall be taken when a new start-up is made.

B. The tests required to be performed by the laboratory on a filling sample are the same as those required for blend run quality control samples under Paragraph III above, with the exception of elemental analysis. Filling shall stop immediately upon discovery of any deviation in the filling sample test results from the blend run quality control sample test results for the product being tested. Filling may resume only if upon the testing of additional filling samples, the product obtains test results conforming to the results from the testing of the blend run quality control sample. All cases filled prior to a stoppage shall be tagged defective and disposed of.

#### APPENDIX A

Elemental analysis is performed by: [name of laboratory] A Baird's atomic emission spectrometer or other appropriate equipment shall be used to determine the parts per million of the additive metals in the finished oils. The testing equipment test element shall be calibrated in accordance with the standards for [identification name or number of the blending formula] supplied by [name of additive manufacturer] via Renuzit.

Blend run quality control samples sent to [name of laboratory] for analysis shall be identified by the SAE grade of the product and by the blend run identification number preceded by the number representing the month of the year in which the oil is

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produced. [Name of laboratory] shall verbally transmit to Renuzit the results of the elemental analysis on the day the analysis of the blend run quality control sample is performed, with written confirmation to be received by Renuzit within five working days after completion of the tests.