# 3 case Application of the Merger Guidelines: The Proposed Merger of Coca-Cola and Dr Pepper (1986)

Lawrence J. White

## Introduction

On February 20, 1986, the Coca-Cola Company announced its intentions to purchase the Dr Pepper Company and merge the operations of the two companies. Three and a half weeks earlier, PepsiCo had announced its intentions to purchase the Seven-Up Company, which was a subsidiary of the Philip Morris Corporation. These two mergers would have meant the consolidation, respectively, of the first and fourth and the second and third largest sellers of concentrate for carbonated soft drinks in the United States.

Exercising its antitrust enforcement responsibilities, the Federal Trade Commission (FTC) in June 1986 decided that these mergers were likely to be anticompetitive and declared its preliminary decision to oppose them. In the face of this opposition, PepsiCo and Seven-Up called off their merger, but Coca-Cola and Dr Pepper persisted to the point of a small-scale trial in Federal District Court.

This case is important in at least two respects. First, it represented a federal government antitrust challenge to a major merger at a time when critics of the Reagan administration's antitrust enforcement agencies were claiming that these agencies had largely abandoned enforcement. Second, it is a case in which sophisticated economics reasoning shaped and influenced the structure of many of the arguments advanced by both sides, as well as much of the trial opinion written by the judge in this case.

**Lawrence J. White** was an expert witness for the Federal Trade Commission in the mergers described in the text. The views and opinions expressed in this chapter, however, do not necessarily represent those of the Federal Trade Commission nor of the FTC staff lawyers and economists who worked on the cases. Thanks are due to Marilyn Frankel, John Kwoka, William Lynk, Gordon Spivak, and Gregory Werden for their helpful comments on an earlier draft.



This case study will provide the background, analyze the economics arguments advanced by both the plaintiff (the FTC) and the defendant (Coca-Cola) in this antitrust case, and evaluate the outcome. Though reference will also be made to the merger of PepsiCo and Seven-Up, our primary focus will be the merger of Coca-Cola and Dr Pepper.

## Industry Background

Coca-Cola, Dr Pepper, PepsiCo, and Seven-Up are usually identified as producers of carbonated soft drinks (CSD).[1] Whether CSD was the appropriate market for judging the competitive consequences of these mergers—or whether, for example, the market should have been construed to be much wider and encompass all potable liquids—was an important issue in the FTC's investigation and the eventual trial. But because of the companies' primary identification as CSD producers (and because the FTC and the trial judge did conclude that CSD was the relevant market), some background information on the CSD industry should prove useful for the discussion that follows.

The national CSD producers are, for the most part, manufacturers of flavoring concentrate.[2] They sell the concentrate to independent local bottlers, who add carbonated water and sweetener and package the finished CSD into bottles and cans. Bottlers provide the subsequent distribution function, delivering the packaged CSD to food stores, vending outlets, and other retail outlets. Many bottlers also deliver syrup (concentrate plus sweetener) to restaurants and other "fountain" accounts. Bottlers frequently handle the brands of more than one concentrate manufacturer, but most manufacturers place "flavor restrictions" on the ability of bottlers handling their brands to handle competing companies' brands with similar flavors. Thus, in some areas the local Coca-Cola bottler may handle Seven-Up, but would never also distribute Pepsi or Royal Crown. The concentrate manufacturers generally restrict their bottlers to distribution in local geographic areas. Finally, in the 1980s a few concentrate manufacturers—especially Coke and Pepsi—began absorbing some of their bottlers into the parent companies, so that the latter were becoming more vertically integrated.

The CSD industry involves large dollar sales volumes. The wholesale value (at the bottler level) of CSD sales in 1984 was approximately \$23.5 billion.[3] The comparable value of concentrate sales in the same area was approximately \$3.5 billion, and the retail value of that CSD was probably around \$35 billion. Table 3-1 provides an estimate of the 1985 retail sales shares of the leading CSD producers.

**Table 3-1**
**U.S. Retail Sales Shares of Leading Producers of Carbonated Soft Drinks, 1985***

| *Producer* | *Share** |
|---|---|
| Coca-Cola Co. | 37.4% |
| PepsiCo | 28.9 |
| Philip Morris (Seven-Up) | 5.7 |
| Dr Pepper Co. | 4.6 |
| R. J. Reynolds (Sunkist, Canada Dry) | 3.0 |
| Royal Crown Cola | 2.9 |
| Procter & Gamble (Orange Crush, Hires Root Beer) | 1.8 |
| Others (including supermarket brands) | 15.7 |

*Sales shares for each company include all brands produced by that company.
*Source: F.T.C.* v. *Coca-Cola Co.* 641 F. Supp. 1128, 1134.

# The Legal and Procedural Background

Section 7 of the Clayton Act instructs the Department of Justice (DOJ) and the Federal Trade Commission (FTC) to prevent those mergers and acquisitions "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition or to tend to create a monopoly." The 1976 Hart-Scott-Rodino Amendments to the Clayton Act require that the two agencies be given advance notice of any merger or acquisition that is above a specified size. With only a few exceptions,[4] the division of cases for investigation of potential violations is largely arbitrary. Historical expertise in handling cases in the relevant industry is the major criterion.

After notification of the proposed merger, the agencies usually have thirty calendar days to conduct an initial investigation.[5] At the end of that period (or sooner), the agency can indicate that it will not oppose the merger. Or the agency can make a request for more information (e.g., about detailed sales data, entry experience) from the merging parties. After the new information is received, the agency has another twenty days for analysis.[6] At the end of this second period,[7] the merger can automatically proceed unless the agency obtains a preliminary injunction (PI) from a Federal District Court. Frequently, the simple announcement by the DOJ or the FTC that they intend to seek a PI will cause the merger partners to cancel their deal. But some merger candidates persist and contest the PI. The legal dispute over the PI usually involves a relatively rapid "minitrial" on the merits of the antitrust issues; in order to grant a PI the court need not resolve all issues, but it must find "that a challenged acquisition is reasonably likely to lessen competition substantially,"[8] so that a full-length investigation and trial would be warranted. If the merger candidates win the minitrial, they can proceed with their merger, but the agencies can still try to prosecute to unscramble the merger through a full-length legal proceeding (which can often extend, including pretrial depositions and document requests, for two or three years or even longer).[9] If the agencies win the minitrial for the PI, the merger is temporarily stopped, but the merger candidates can nevertheless persist with their legal efforts, hoping to reverse their fortunes through a full-length legal proceeding. Most merger candidates, though, cancel their plans if they lose the minitrial and thus fail to prevent the agencies from obtaining the PI.

For the two proposed CSD industry mergers under discussion, the FTC was the logical agency to conduct the investigation. The FTC in the 1970s had conducted an extensive investigation of the CSD bottling industry and the practice of the syrup manufacturers of granting exclusive sales territories to their bottlers. In 1978 the FTC declared that this practice was anticompetitive. (Congress in 1980, however, legislatively overruled the FTC and carved out a special exemption in the antitrust laws—the Soft Drink Interbrand Competition Act—for the territorial exclusivity practices of the syrup manufacturers.)

The FTC's investigation of the two mergers lasted approximately four months.[10] At the end of June 1986 the Commission decided unanimously[11] that the mergers were likely to be anticompetitive and instructed the FTC's lawyers to seek a preliminary injunction to halt the proposed mergers.[12] Faced with this challenge, PepsiCo and Seven-Up canceled their merger plans. Coca-Cola and Dr Pepper persisted and indicated their willingness to contest the granting of the PI. Under such circumstances, the parties are usually granted an expedited hearing before a Federal District Court judge. In mid-July, Judge Gerhard Gesell conducted a minitrial in Washington, D.C., on the merits of the FTC's claim that the merger between Coca-Cola and Dr Pepper was likely to be anticompetitive. The FTC presented four witnesses: an executive from Procter & Gamble (which owned a soft-drink company, Crush International, that had a comparatively small market share); a Dr Pepper bottler; an owner and operator of snack- and lunchwagons, who bought soft drinks from bottlers and resold them to consumers; and an economist, as "expert" witness. Coca-Cola presented three defense witnesses: the president of Coca-Cola's American operations and two economists, as expert witnesses. The trial lasted four days.

On July 31, 1986, Judge Gesell delivered his opinion. He found in favor of the FTC and granted the PI, effectively halting the merger. Coca-Cola initially wanted to appeal Judge Gesell's ruling, but Dr Pepper decided to withdraw from the acquisition. Apparently, the latter company did not want to take its chances in a potentially lengthy proceeding that would first have to be heard by an FTC administrative law judge and then by the Commission itself. The proposed merger was effectively dead.

# The Parties' Arguments

The economic arguments advanced by both sides at trial[13] were largely structured by the Department of Justice's Merger Guidelines[14] (discussed in the introduction to this section): the market-definition paradigm (including a price-increase standard), a quantitative focus on market shares, an analysis of entry conditions, and a discussion of other market conditions that might help or hinder coordinated behavior among the CSD producers.

## The FTC's Arguments

The FTC's economic case against the mergers rested on four propositions: (1) the relevant product markets were CSD concentrate and CSD itself, and the relevant geographic markets were a national market and also local markets that could be approximated by metropolitan areas; (2) these markets were highly concentrated, and the proposed merger would increase the levels of concentration substantially; (3) entry by new producers or expansion by small existing producers—that might otherwise thwart efforts at exercising market power—was difficult, risky, and time consuming; and (4) consequently, the merger was likely to result in a substantial lessening of competition.

**Market Definition** The FTC's product-market-definition claim was based on deposition (interview) and discovery (document) evidence. Carbonated soft drink company executives, when asked, indicated that their primary competitors were other CSD producers. Their pricing and marketing strategies were developed with an eye toward other CSD producers—not (as claimed by the defendant) toward the sellers of fruit juices, milk, coffee, tea, or other beverages. The information on rivals' prices and sales volumes that they regularly collected pertained almost exclusively to other CSD producers—and not the producers of the other beverages. The marketing documents uncovered by the FTC's discovery requests (see footnote 10) told the same story.

Further, many industry executives, when asked if they thought the CSD producers could collectively raise the retail prices of CSD by 10 percent (a more conservative standard than that of the Merger Guidelines) and not be thwarted by consumers' switching to other beverages, replied affirmatively. Also, the cost of the CSD concentrate was only a small fraction—approximately one-tenth—of the retail price of CSD, and there was little room for substitution of other inputs for concentrate. Thus, there appeared to be considerable room for an industrywide increase in the price of *concentrate*—well beyond the 5 percent DOJ benchmark—that would not decrease industry sales appreciably and would be jointly profitable for the concentrate manufacturers. Hence, both CSD concentrate and CSD itself appeared to be relevant antitrust markets for the purposes of analyzing the competitive effects of a merger.

The economics staff at the FTC had also developed econometric studies of CSD retail prices in local metropolitan areas that were based on marketing data collected by the A. C. Nielsen Co. on a weekly and biweekly basis. The estimation results appeared to indicate that CSD sellers could, collectively, exercise market power.[15] But, in the very limited time available to prepare for the mid-July trial, some of the potential weaknesses in the estimations could not be adequately corrected, and these results were not part of the evidence introduced by the FTC to support its market-definition claim. If the case had subsequently gone to a lengthy trial, modified forms of these estimations would likely have been used to support the FTC's position.

Since the merging entities were sellers of CSD concentrate, the FTC claimed that CSD concentrate was a market. Also, because the CSD sellers could influence the wholesale and retail prices of CSD itself through sales promotions and direct discounts, CSD itself was a market.[16] Further, because the CSD-concentrate manufacturers appeared to be able to influence prices separately (e.g., through specific rebates and promotions) in bottlers' sales to food stores, sales through vending machines, and sales to fountain accounts, these three distribution lines were also designated as separate markets.

With respect to geography, the FTC claimed that the United States was a market that met the Merger Guidelines criteria; imports were negligible. Further, the FTC argued, individual local areas—for which metropolitan areas, as measured by the Nielsen marketing surveys, could be a suitable proxy—were also relevant markets. Through their adjustments of marketing promotions, rebates, and discounts, the CSD producers could charge effectively different prices in different areas. The producers' practice of requiring their bottlers to sell only within the latters' designated marketing areas ensured that arbitrage shipments of concentrate or CSD by bottlers would not foil efforts at price discrimination. The Nielsen marketing data mentioned above, along with similar data shown to the Commission by the merging parties (but intended to demonstrate other things), supported this view.

The claim that local areas were markets was not a contradiction to the claim that the entire United States was also a market. The CSD producers appeared to be capable (if they could coordinate their behavior) of raising prices significantly in individual local areas as well as nationally, and thus both levels constituted markets.

**Levels of Seller Concentration** Table 3-1 indicates that the leading four sellers accounted for over 75 percent of national market sales. With the merger, the HHI for this national market would have risen by 341 points to a level of 2646.[17] This was well above the Merger Guidelines' 1800 decision point. In addition, of the ninety-one local areas for which the FTC had food store sales data,[18] all ninety-one had market seller concentration levels such that the postmerger HHIs would have been above 1200, and for eighty-one areas the postmerger HHIs would have been above 1800. Of these eighty-one market areas, sixty-six would have experienced HHI increases of over 100 points as a consequence of the merger, again exceeding the Merger Guidelines' criteria.

**Entry** The FTC argued that meaningful entry in CSD concentrate sales and/or significant expansion by smaller firms was difficult, risky, and time-consuming. These problems stemmed from a number of sources.

First, though no specialized resources or talents were required for CSD formulation and production, substantial sums were required for the advertising and promotion of a new soft drink. In the early 1980s, Seven-Up had spent $57 million in the first two years of promotion for its Like Cola brand. Coca-Cola documents indicated that the company intended to spend $44 million and $42 million, respectively, on first-year promotional efforts on its new Cherry Coke and Minute Maid soft-drink brands in the mid-1980s. (By comparison, the first-year promotional expenditures for new products in other food lines were typically in the range of $5 to $10 million.[19])

The significance of these advertising and promotion numbers is that they represent "investments" that are highly risky; they are sunk. Unlike an investment in plant and equipment, which usually has substantial salvage value even if the planned product fails, investments in advertising and promotion have little salvage value if the product fails—as, indeed, Seven-Up's Like Cola did. An alternative to undertaking large-scale (risky) promotional expenditures would have been a slower, less costly (and hence less risky) "roll out" of a soft drink in a few regional markets, with the process extending over four or five years or more. This was the strategy chosen by some smaller CSD sellers. But this slower expansion would be less likely to be an effective check on the exercise of market power that might follow a merger of Coke and Dr Pepper. Also, even before the marketing effort began, product formulation and testing could take approximately two years, thus delaying entry and impeding the ability of entrants to check rapidly the exercise of market power.

Second, for sales to food stores and through vending outlets, access to distributors—the bottlers—appeared to pose difficulties to entrants. To be an effective distributor, a bottler appears to need a sales volume (from all its brands) of at least 10 to 20 percent of a local market.[20] Thus, an entrant, with a small market share, would initially have to "piggyback" on the brands of others and use existing bottlers. But the flavor restrictions imposed on bottlers by most producers would have made this difficult or impossible in many markets. While an entrant trying to sell a new banana cream soda might not face this problem, someone trying to sell a "new, improved cola" would. Though alternative forms of distribution—through beer distributors, dairies, independent food brokers, or direct distribution to supermarket warehouses—were possible and had been or were being used by some smaller CSD producers, these alternatives appeared to be less effective. All of the larger companies (and most of the smaller ones) used only bottlers. The direct promotional effort provided by a bottler seemed to be the best way of winning the battle for supermarket shelf space and marketing cooperation.[21]

Third, for vending and fountain sales, the limited number of buttons on a machine and spigots at a fountain posed entry barriers for smaller entrants. A company with, say, 2 percent of sales of CSD in a local market might be able to convince food retailers elsewhere to give it approximately 2 percent of the shelf space in their soft-drink section. But with only six or eight buttons on most vending machines (which are usually owned and operated by bottlers), and about the same number of spigots on most fountain dispensers, the small entrant with 2-percent sales would be unlikely to gain access to these limited slots.[22] (The alternative strategy, of course, would be to try for the big marketing push that would generate a large enough market share to justify vending machine and fountain spigot allocations; but as explained above, this large effort would be considerably more risky.)

Overall, then, entry was not easy. It was true that a few brands had entered the market, and some regional or niche brands had enjoyed brief periods of success; but neither individually nor collectively could they be expected to serve as a competitive check on the exercise of market power by the larger CSD procedures. Even a marketing giant like Procter & Gamble, through its ownership of Crush International, had not been able to make much of a dent in the market; P&G's brands accounted for less than 2 percent of retail sales. Also, though private-label supermarket brands of CSD accounted for 10 to 15 percent of foodstore CSD sales in some areas, they too were unlikely to be a check on the exercise of market power, even in food-store sales,[23] and certainly not in vending and fountain sales.

**Competitive Consequences** The FTC argued that the merger of the first- and fourth-largest sellers of CSD in a highly concentrated market was likely to reduce the level of competition and make coordinated behavior among CSD producers easier. Direct competition between Coca-Cola's Cherry Coke and Mr. Pibb brands and Dr Pepper's brands would be eliminated. Also, with one fewer major player in the soft-drink markets, coordinated behavior—higher list prices for CSD concentrate and/or reduced rebates and promotional expenditures—would be more likely, as the major firms would find it easier to police themselves and hence would be less fearful that one among them might "cheat," cut prices, and expand promotion.

As an indicator that such behavior was already occurring to some extent, the previous decade's profit data—return on stockholders' equity—showed comparatively high rates of return for the major CSD producers. A number of critics have claimed that these accounting data may not be accurate indicators of competitive or noncompetitive profits.[24] The FTC did not use these data as evidence, largely because the Guidelines approach argues that Section 7 of the Clayton Act should be forward-looking: Will this merger make things worse? Past profit rates are not strictly relevant in addressing this question. Still, these data suggested (at least to this author) that noncompetitive, coordinated behavior was possibly already occurring in this concentrated industry and could become worse after the merger.[25]

Also, to the extent that the Coca-Cola Company decided to consolidate its distribution through one local bottler in areas where Coke and Dr Pepper had previously used separate bottlers, the smaller CSD manufacturers who had piggybacked with Dr Pepper might find that their volume alone was insufficient to achieve adequate economies of scale in distribution and thus would suffer higher costs; the same would be true for potential entrants. In addition, if the Dr Pepper brand continued to be distributed through a separate bottler that was also used by Pepsi, that bottler might serve as a device for the exchange of information between Pepsi and Coke and thus facilitate the coordination of behavior between the two.

The fact that CSD is not an absolutely uniform product—each company's brands and flavor formulations are different, and most brands come with at least two alternative sweeteners, in a variety of sizes, and with a variety of promotional possibilities—did not appear to be a bar to the possibility of coordinated behavior among the major CSD producers, with anticompetitive consequences. The CSD producers might simply raise wholesale prices of CSD concentrate, without changing promotional activity. Or they might cut back on the latter, reducing the frequency of special



promotions or reducing advertising efforts. Again, the previous decade's profits data suggested that such behavior was possible.

The FTC did not directly address the efficiencies arguments raised by the defense (see discussion following), considering them largely irrelevant to its case. If the case had gone to a full trial, the FTC surely would have tried to develop evidence to refute Coke's claims.

## Coca-Cola's Arguments

The Coca-Cola Company, as defendant, argued that the merger would not have anticompetitive consequences. Its defense centered on three propositions, any one of which, if valid, would imply that the merger could not adversely affect competition: (1) the relevant market was all potable beverages, not just CSD; (2) even if the market were just CSD, entry was easy into CSD; (3) even if entry were difficult, the only competition that mattered was the head-to-head rivalry of Coke and Pepsi. Further, the merger would achieve efficiencies for the combined entity and hence would promote competition.

**Market Definition** The defense argued that Coke (and other CSD brands) competed against all other beverages, not just against each other.[26] They noted that CSD consumption had expanded substantially in the past few decades, apparently at the expense of more traditional beverages, such as coffee. All these beverages were actual and potential substitutes for CSD and hence competed with CSD. Also, because beverage manufacturers typically operated and sold their products nationwide, as did Coke and Dr Pepper, the geographic market should be the entire United States. In this larger market, CSD was only 25 percent of all beverage consumption, and the postmerger HHI was only 739,[27] well below the Merger Guidelines' minimum decision point of 1000. Hence, the merger did not increase the likelihood of the exercise of market power.

Like the FTC, Coca-Cola did not offer any quantitative evidence to support its market definition claim. PepsiCo, in defending its merger, however, had presented the FTC with an econometric study that used time series price and quantity data to estimate a demand curve for CSD. The study indicated that the demand for CSD was sensitive to the prices of other beverages. This, PepsiCo claimed, showed that the market should be defined to include other beverages. (What they did not demonstrate, however, was whether the cross-elasticity was high enough to thwart a concerted effort by CSD producers to raise prices.)

**Entry** Coca-Cola argued that even if the market were defined as only CSD, entry into CSD production and sale was nevertheless easy, as was expansion by smaller producers. There were no specialized resources involved in the production and sale of CSD, and economies of scale were not significant. It was easy to develop a flavor and produce the concentrate, or specialized "flavor houses" could be hired to do it. Bottlers and bottling capacity were available for distribution; and warehouse distribution, independent food brokers, and beer distributors were suitable alternatives.

The defense pointed to large, diversified food-products manufacturers—such as Kraft, Beatrice, and Borden—as potential entrants, as were beer producers. Further, R. J. Reynolds was in the process of selling its Canada Dry and Sunkist brands to Schweppes; and though its attempt to sell Seven-Up to PepsiCo had been stopped by the FTC, Philip Morris would surely try to sell Seven-Up to someone else. Both of these companies were possible reentrants if the existing CSD producers tried to raise their prices and thereby earn extraordinary profits.

Coca-Cola also pointed to recent entrants and smaller CSD producers—such as Shasta, Fanta, Hansens, Soho Natural, Canfield, Seagrams, and others—who either had or were capable of expanding their sales significantly. In addition, supermarket private-label brands were important in some areas.

In sum, entry was easy, so the high apparent HHI levels in the CSD market (if it were a market) were competitively irrelevant. Easy entry would keep in check any effort by the CSD producers, even after the merger of Coke and Dr Pepper, to coordinate their behavior and raise prices.

**Structural Characteristics of the Market** Coca-Cola further argued that, even if entry were difficult, the characteristics of the CSD industry made difficult any coordinated behavior to raise prices. There were too many product types and sizes and too many promotional opportunities. It would be difficult for any one firm to police or monitor the others in any informal understanding to raise prices or reduce promotion, and thus each firm would have a great incentive to cheat on any such arrangement. Coordinated efforts to raise prices and profits were therefore doomed, even if Coke merged with Dr Pepper. Only the merger of Coke and Pepsi might stifle competition and cause prices to rise.

The defense pointed to the decline in the real (inflation-adjusted) price of CSD over the previous two decades and argued that this showed the great competitive vigor of the CSD producers, which had persisted despite an increase in Coke's market share (through internal growth) that was greater than the increase in Coke's market share that would occur through the purchase of Dr Pepper.[28] Coke offered an econometric study that combined time series and cross-section data on weekly and biweekly prices and market shares of CSD sellers in local metropolitan areas. The study indicated that prices and concentration were inversely correlated—the opposite of what a coordinated-behavior hypothesis would imply.[29] Finally, Coke offered evidence on the stock market's reaction at the time of the announcements of the Pepsi–Seven-Up and Coke–Dr Pepper mergers; Coke argued that the stock prices of its rivals in the CSD industry fell, indicating that the stock market believed that the mergers would be procompetitive rather than anticompetitive.[30]

In sum, as long as Coke and Pepsi did not merge, they would slug it out with each other, and the market would remain competitive. The Coke–Dr Pepper merger could only aid this process by making the combined entity more efficient.

**Efficiencies** Coca-Cola argued that the merger would allow the combined entity to consolidate the operations of Coke and Dr Pepper and thus achieve cost savings and efficiencies. Also, Coke felt that it could use its marketing skills and resources to improve the profitability of Dr Pepper's operations.

## Judge Gesell's Opinion

On July 31, 1986, Judge Gerhard Gesell delivered his decision.[31] He found in favor of the FTC, accepting many of the agency's crucial propositions and supporting arguments.

First, the relevant product market was CSD.[32] The relevant geographic markets were the entire United States and thirty-two "significant population areas" in the seven contiguous states of Texas, Louisiana, Mississippi, Alabama, Georgia, Tennessee, and Arkansas. "The major participants in the market . . . make pricing and marketing decisions based primarily on comparisons with rival carbonated soft drink products, with little if any concern about possible competition from other beverages such as milk, coffee, beer or fruit juice."[33]

Second, these markets were highly concentrated, and Coke and Dr Pepper were active competitors in them. "There is general agreement that the market for carbonated soft drinks is already highly concentrated. It consists of a few major concentrate companies and a number of minor concerns, not all of which do business nationally."[34] "The stark, unvarnished truth is that Dr Pepper brand has been a staunch effective competitor in the market, that Coca-Cola Company has tried to stifle it by developing its own pepper drink and by seeking to replace it with its new Cherry Coke brand in fountain accounts at considerable expense and that it has failed. It is now seeking to buy out its competitor."[35]

Third, entry into the market was not easy. Access to effective bottlers was one problem. "Other companies seeking to seriously challenge the dominance of Coca-Cola Company and PepsiCo by entering in the major flavor segments would probably have serious difficulty finding effective distribution. . . . Relatively few independent bottlers have the strength to compete on a major scale. Moreover, the strong independent bottlers are unlikely to be available for major entry due to their own flavor restrictions. . . . Alternative channels of distribution are unproven and of dubious effectiveness. . . . As a further concern, effective access to bottlers is likely to become even more difficult in the future as dominant companies increasingly focus their energies on controlling their distribution network even more tightly."[36] Further, "To establish a major new brand requires large expenditures for advertising to fix the brand name and image in the mind of the consumer—expenditures that cannot be recovered if the introduction fails. . . . Effective entrants must also match the considerable promotional budgets of the dominant companies in targeting their brands for effective distribution through retailers. . . . Finally, it has been the experience of the industry that effective entry against the dominant companies is likely to require years of sustained effort for any continuing success. . . ."[37]

Fourth, the merger would have anticompetitive consequences. Judge Gesell focused primarily on the loss of competition between Coke and Dr Pepper. "Once the Dr Pepper brand joins the Coca-Cola Company line much of this direct rivalry will probably cease."[38] He was clearly uncomfortable, however, with the FTC's proposition that greater concentration would lead to reduced competition generally in the market.[39] "No tendency in that direction has yet been evidenced and there is no proof that the mere addition of Dr Pepper to Coca-Cola Company's line, standing alone, will trigger a foreseeable development of this kind. The present intensity of competition between Coca-Cola Company and PepsiCo does not seem likely to diminish in the immediate future."[40] "But," he also added, "the fact remains that if the proposed acquisition is consummated there will be one less independent factor in the market to challenge the dominance of Coca-Cola Company."[41]

Instead, he was more comfortable with the legal argument that had been advanced by the FTC at the trial. Citing an earlier Supreme Court antitrust decision,[42] he wrote that "[g]iven [Congress'] dominant legislative desire to curb the economic concentration of power, it is unnecessary to speculate about the economic effect of the proposed acquisition. Without more, substantial mergers of this kind in heavily concentrated industries are presumed illegal. . . . A court must be guided by the view that 'a merger which produces a firm controlling an undue percentage share of the relevant market, and results in a significant increase in the concentration of firms in that market, is so inherently likely to lessen competition substantially that it must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anticompetitive effects.' "[43]

Finally, he paid little attention to Coca-Cola's efficiency arguments. "Any federal judge considering regulatory aims such as those laid down by Congress in Section 7 of the Clayton Act should hesitate before grafting onto the Act an untried economic theory such as the wealth-maximization and efficiency-through-acquisition doctrine expounded by Coca-Cola Company. . . . To be sure, efficiencies that benefit consumers were recognized as desirable but they were to be developed by dominant concerns using their brains, not their money by buying out troubling competitors."[44]

In sum, "The acquisition totally lacks any apparent redeeming feature."[45] "A preliminary injunction in the form attached shall issue forthwith."[46]

## Aftermath

The FTC's successful challenge to the Pepsi–Seven-Up and Coke–Dr Pepper mergers did not spell the end of the restructuring of the carbonated soft drink industry. Philip Morris was determined to sell Seven-Up. In mid-July 1986 it sold the international operations of Seven-Up to PepsiCo,[47] and later in the year it sold Seven-Up's domestic operations to a private investor group headed by the venture capital firm of Hicks & Haas. Dr Pepper, thwarted in its attempt to merge with Coca-Cola, was soon bought by a different group of private investors that was also headed by Hicks & Haas. Earlier, Hicks & Haas had also bought A&W Brands, and in November 1986 Hicks & Haas bought Squirt. Thus, by the end of 1986, this collection of brands controlled by Hicks & Haas had become the third-largest CSD producer in the industry, accounting for about 10 percent of industry sales.[48]

Further, in July 1986, while the Coca-Cola case was still under challenge, Cadbury-Schweppes (which already produced Schweppes mixers) bought the Canada Dry and Sunkist brands from R. J. Reynolds.[49] Also, in 1989, Cadbury-Schweppes acquired the Crush and Hires brands from Procter & Gamble. Cadbury-Schweppes thereby became the fourth-largest CSD producer.

Though Coca-Cola and PepsiCo had been thwarted in their acquisition efforts, their market shares continued to rise in the late 1980s because of internal expansion, so that the market shares of the two companies in 1991 were above 40 percent and 30 percent, respectively. Table 3-2 provides the market shares of the leading CSD producers as of 1991.[50]

Accordingly, despite the FTC actions, the CSD market has undergone considerable changes and significant consolidation. But these changes do not appear to pose the same level of competitive threat as was posed by the two challenged mergers; and, indeed, it is possible that the larger market shares of the Dr Pepper–Seven-Up and Cadbury-Schweppes merged entities might allow them to offer a more effective competitive challenge to the two industry leaders.[51]

Also, during the late 1980s the Department of Justice indicted and convicted a number of CSD bottlers for price-fixing in local markets. There was no indication, however, of any direct involvement by any CSD concentrate company.

Finally, during the late 1980s both Coca-Cola and PepsiCo continued their downstream integration into bottling, through acquisitions of their formerly independent bottlers. By 1990 Coca-Cola and PepsiCo each had acquired bottling facilities that allowed them to bottle about 50 percent of their bottled sales; they also had minority (15 to 20 percent) ownership stakes in independent bottlers, accounting for another 20 percent of the sales of each. It appears that the primary motive for this vertical integration has been to improve the efficiency of the two companies' distribution systems.[52]

## Conclusion

The FTC's challenge to the Coca-Cola–Dr Pepper merger represented a fruitful application of microeconomics. The Department of Justice's Merger Guidelines structured many of the arguments advanced by both sides. Sophisticated reasoning and econometric studies buttressed much of the analysis. The economics experts hired by each side differed in their interpretations of the relevant facts and of the weights that should be put on various arguments, but there was little disagreement on the fundamental economics propositions that should be applied. In addition, from an economics perspective, Judge Gesell's decision was largely a sensible one, except for his reluctance to accept the FTC's argument concerning the likely competitive consequences of an increase in market concentration.

From this same economics perspective, however, one discordant note in his decision should be mentioned. In his discussion of the likely effects of the merger, Judge Gesell wrote the following:

> At the preliminary injunction hearing economists, drawing on experience in this multi-faceted discipline, flatly disagreed as to the significance of the proposed acquisition upon competition in the market. These sincere professionals are theoreticians in an imprecise field. They have never sold a can of carbonated soft drink and indeed the principal economist for Coca-Cola Company frankly admitted he had little knowledge of the underlying facts.
>
> The Court should not, in any event, rely on the economic testimony in reaching a conclusion about the probable effects of the proposed acquisition given the concentrated nature of the market just outlined. Section 7 of the Clayton Act was not designed to support a particular economic theory; it was directed at what Congress in the exercise of its own common sense perceived.[53]

Yet, as we have argued in this chapter, economic theory significantly structured many of the arguments that were presented to Judge Gesell by both sides and was an important influence on his eventual decision. It can only be hoped that future antitrust litigants and judges will listen more to the "music" of the general nature of the arguments and the opinion and less to the specific words quoted above.

**Table 3-2**
**Market Shares of Leading Producers of Carbonated Soft Drinks, 1991***

| *Producer* | *Share* |
|---|---|
| Coca-Cola Co. | 41.3% |
| PepsiCo | 32.9 |
| Dr Pepper–Seven-Up Co. | 10.2 |
| Cadbury-Schweppes | 3.3 |
| Royal Crown Co. | 2.4 |
| Others | 10.0 |

*See note 50 in text.

*Source: Beverage World, 1992–1993 Databank* (1992, p. 25).

## Notes

1. Further information on the CSD industry can be found in Wayland (1992), Muris, Scheffman, and Spiller (1992), and Gasmi, Laffont, and Vuong (1992).
2. The discussion that follows is in terms of generalities. There may be a few minor exceptions to the general descriptive elements provided.
3. *F.T.C.* v. *Coca-Cola Co.*, 641 F. Supp. 1128, 1133 (1986).
4. For example, mergers in regulated industries are largely the province of the Department of Justice.

5. If the proposed merger involves a cash tender offer, the relevant time is fifteen days.
6. If a cash tender offer is involved, the period is ten days.
7. The actual time from announcement to agency decision can extend for more than fifty days if the merging parties require time to respond to the agency's request for more information, or if they agree to a delay in consummating the merger in the hopes of thereby eventually obtaining a favorable decision. This is a frequent occurrence.
8. *F.T.C.* v. *Coca-Cola.*, 641 F. Supp. 1128, 1134 (1986).
9. For a DOJ challenge, the full trial would be in a Federal District Court. For an FTC challenge, the full trial would be before an administrative law judge, with eventual review before the full Commission. For both routes, appeals could then be made to a Federal Circuit Court of Appeals and then possibly to the U.S. Supreme Court.
10. Most of the extension beyond fifty days was due to the companies' delays in responding to the FTC's information requests. In the end the four companies delivered over 600 file boxes of documents to the agency.
11. The vote was 4–0; the fifth commissioner did not participate in the case because of a possible conflict of interest.
12. A few weeks before the FTC decision the Royal Crown Cola Company filed suit in Federal District Court in Georgia to stop the two mergers, but that suit was held in abeyance pending the FTC's actions.
13. In most cases, the witnesses (if any) for each side testify at trial through a process of direct examination by their own side's attorney (to draw out the witness's story) and then cross-examination by the other side's attorney (to try to undermine or cast doubt on that story). In the Coca-Cola case, which was tried only before a judge and not before a jury, Judge Gesell asked the economic experts for both sides to submit affidavits to him (and to the other side) before the trial, which he read and entered into the court record. Thus, the experts did not have to go through direct examination but only through cross-examination by the other side. This procedure saved valuable court time, allowed each side to present its economic arguments in a relatively polished fashion, yet also allowed the opposing side to receive and review those arguments with adequate time for rebuttal. It is a procedure that should be copied in other judge-only trials.
14. In June 1982, at the same time that the DOJ issued its Merger Guidelines, the FTC issued a "Statement on Horizontal Mergers." It was the DOJ Guidelines, however, that largely shaped the FTC's investigation of the CSD mergers and its prosecution of the case.
15. The econometric studies were similar to those done by Baker and Bresnahan (1985) for beer brewers.
16. The FTC also considered the possibility that only branded CSD—that is, excluding private label CSD sold by supermarkets—might be a market. But this proposition was never formally advanced by the Commission.
17. By using a slightly different base for total sales, the FTC developed other HHI estimates that were somewhat different but not appreciably so. The FTC also developed a postmerger HHI estimate for the fountain market that was even higher.
18. These were areas that were monitored by Coke or Dr Pepper.



19. Also, among all of the categories of food producers listed by the Internal Revenue Service's *Statistics of Income, Corporate Returns,* the advertising-to-sales ratio of the CSD producers is second only to that of the producers of distilled spirits—and well above all of the remaining categories.
20. The interview data indicated that this minimum efficient scale was a relative concept—a market share concept—in these local markets. It appeared that a bottler needed to attain this 10 to 20 percent of the local market in order to gain supermarkets' attention and cooperation in promotional activity.
21. Dr Pepper itself had tried warehouse delivery methods in a few markets in the 1950s and had abandoned it as ineffective. Also, in the 1980s Coke and Pepsi began buying some of their bottlers' franchises and thus vertically integrating into distribution. These actions meant even greater difficulties for potential entrants.
22. Coca-Cola presented data on its profit margins in the fountain and retail areas that were consistent with this proposition. The profit margins were appreciably higher in the former area.
23. Either the supermarkets might go along with the major producers in raising prices or, even with lower prices, they might not attract enough customers to foil the major producers' price rise. In this latter event, the relevant market would therefore be restricted to branded CSD.
24. See Benston (1982), Fisher and McGowan (1983), and Fisher (1984). For a rebuttal, see Horowitz (1984), Long and Ravenscraft (1984), Martin (1984), and van Breda (1984).
25. For subsequent evidence that Coca-Cola and PepsiCo have behaved noncompetitively, see Gasmi, Laffont, and Vuong (1992).
26. When first informed of this position by Coca-Cola's counsel at trial, Judge Gesell responded by saying, "So we've got everything in [the market], milk and tea, Pepto Bismol, anything potable." Coca-Cola's counsel replied, "I'll concede that Pepto Bismol is not in the market, your honor" (trial transcript, p. 18).
27. These data pertain to a beverage market that excludes wine and distilled spirits.
28. In response, the FTC pointed out that declining real prices were not automatically or necessarily a sign of competitive vigor. Elementary microeconomic theory indicates that even a monopolist would lower its price if (other things remaining unchanged) the costs of inputs decreased or productivity improvements caused production costs to decrease. It was likely that these cost decreases and productivity improvements were the driving forces behind the real price declines in CSD, and thus no implications about competition could be drawn from these claims.
29. In response, the FTC argued that the very short-term nature of the data—weekly and biweekly observations—cast doubt on the implications that Coca-Cola tried to draw from the study. Instead, the inverse relationship between prices and market shares might be largely (or entirely) the result of periodic "specials" on various brands, with many consumers buying large inventories of those brands at that time (and thus increasing the very short run-market shares of those brands at those times). The coordinated behavior hypothesis, by contrast, is a proposition about long-run relationships and should be tested with longer-run (e.g., annual) data. Coca-Cola offered another econometrics study, using the same data, that showed that market share stability was not positively

related to market concentration (which, again, would be inconsistent with an implication of the coordination behavior hypothesis). The FTC offered a similar critique.

30. In response, the FTC argued that a slightly different interpretation of the data yielded the opposite conclusion. The methodology of looking at rival companies' share price reactions was first suggested by Baxter (1980). For some applications, see Eckbo (1983) and Eckbo and Wier (1985).
31. The full opinion is found in *F.T.C.* v. *Coca-Cola Co.,* 641 F. Supp. 1128 (1986).
32. Judge Gesell did not make any distinction between sales of CSD concentrate and sales of CSD itself.
33. 641 F. Supp. 1128, 1133 (1986).
34. 641 F. Supp. 1128, 1133 (1986).
35. 641 F. Supp. 1128, 1139 (1986).
36. 641 F. Supp. 1128, 1135–1136 (1986).
37. 641 F. Supp. 1128, 1137 (1986).
38. 641 F. Supp. 1128, 1139 (1986).
39. Based on his questioning of the witnesses at the trial, he seemed to expect that the anticompetitive behavior resulting from the merger would be in the form of predatory price-cutting or predatory promotions by Coke. But this was not the FTC's theory.
40. 641 F. Supp. 1128, 1138 (1986).
41. 641 F. Supp. 1128, 1138 (1986).
42. *U.S.* v. *Philadelphia National Bank,* 374 U.S. 321 (1963).
43. 641 F. Supp. 1128, 1138 (1986).
44. 641 F. Supp. 1128, 1141 (1986).
45. 641 F. Supp. 1128, 1139 (1986).
46. 641 F. Supp. 1128, 1141 (1986).
47. Because there were unlikely to be any domestic competitive consequences from this sale, the FTC did not challenge it.
48. The Dr Pepper and Seven-Up operations were formally merged into one company in 1988.
49. There had been some thought within the FTC of challenging the Schweppes purchase on the grounds that mixers might constitute a separate market, but this notion was not pursued very far. Among the arguments that could be marshaled against challenging the purchase was that Coke, Pepsi, and the other large nonmixer CSD producers were potential entrants into that mixer "market," and hence the merger was not likely to permit the exercise of market power.
50. The HHI in 1991, inclusive of the market shares of lesser companies, was slightly above 2900. The market shares in Table 3-2 are drawn from a different source than those of Table 3-1 and are not strictly comparable; for example, the *Beverage World* market shares for Coca-Cola Co. and PepsiCo for 1985 were 38.7 percent and 30.7 percent, respectively. Nevertheless, by any measure, there has been substantial consolidation in the CSD industry.
51. Empirical support for this argument can be found in Kwoka (1979).
52. Under some circumstances this vertical integration might make distribution more difficult for the smaller producers in the CSD industry and for potential entrants. However, since the major CSD producers had already been imposing "flavor restrictions" on their independent bottlers—in essence, a form of exclusive dealing—rival producers of similar flavors were already excluded from "piggybacking" on the major producers' distributors. The absorption of these bottlers into the Coke and Pepsi parent companies would not appreciably change this situation.
53. 641 F. Supp. 1128, 1138 (1986).

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