ANALYSIS OF AGREEMENT CONTAINING CONSENT ORDER TO AID PUBLIC COMMENT
In the Matter of Reynolds American Inc. and Lorillard Inc.
File Number 141-0168

The Federal Trade Commission ("Commission") has accepted from Reynolds American Inc. ("Reynolds") and Lorillard Inc. ("Lorillard"), subject to final approval, an Agreement Containing Consent Orders ("Consent Agreement") designed to remedy the anticompetitive effects resulting from Reynolds's proposed acquisition of Lorillard.

Reynolds's July 2014 agreement to acquire Lorillard in a $27.4 billion transaction ("the Acquisition") would combine the second- and third-largest cigarette producers in the United States. After the Acquisition, Reynolds and the largest U.S. cigarette producer, Altria Group, Inc. ("Altria"), would together control approximately 90% of all U.S. cigarette sales. The Commission's Complaint alleges that the proposed Acquisition, if consummated, would violate Section 7 of the Clayton Act, as amended, 15 U.S.C. § 18, and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. § 45, by substantially lessening competition in the market for traditional combustible cigarettes.

Under the terms of the Consent Agreement, Reynolds must divest a substantial set of assets to Imperial Tobacco Group plc. ("Imperial"). These assets include four cigarette brands, Lorillard's manufacturing facility and headquarters, and most of Lorillard's current workforce. The Consent Agreement also requires Reynolds to provide Imperial with visible shelf-space at retail locations for a period of five months following the close of the transaction. This Consent Agreement provides Imperial's U.S. operations with the nationally relevant brands, manufacturing facilities, and other tangible and intangible assets needed to effectively compete in the U.S. cigarette market. Reynolds must complete the divestiture on the same day it acquires Lorillard.

The Consent Agreement has been placed on the public record for 30 days to solicit comments from interested persons. Comments received during this period will become part of the public record. After 30 days, the Commission will review the Consent Agreement, and comments received, to decide whether it should withdraw or modify the Consent Agreement, or make the Consent Agreement final.

I. The Parties

All parties to the proposed Acquisition and Consent Agreement are current competitors in the U.S. cigarette market.

Reynolds has the second-largest cigarette manufacturing and sales business in the United States. Its brands include two of the best-selling cigarettes in the country: Camel and Pall Mall. It also manages a number of smaller cigarette brands that it promotes less heavily. These include Winston, Kool, and Salem. Reynolds primarily sells its cigarettes in the United States.

Lorillard has the third-largest cigarette manufacturing and sales business in the United States. Its flagship brand, Newport, is the best-selling menthol cigarette in the country, and the second-best-selling cigarette brand overall. In addition to recently introduced non-menthol styles of Newport, Lorillard manufactures and sells a few smaller discount-segment brands, such as Maverick. Like Reynolds, Lorillard competes primarily in the United States.

Imperial is an international tobacco company operating in many countries including Australia, France, Germany, Greece, Italy, Turkey, Taiwan, the United Kingdom, and the United States. It sells tobacco products in the U.S. through its Commonwealth-Altadis subsidiary. Imperial's U.S. cigarette portfolio consists of several smaller discount brands, including USA Gold, Sonoma, and Montclair.

II. The Relevant Market and Market Structure

The relevant line of commerce in which to analyze the effects of the Acquisition is traditional combustible cigarettes ("cigarettes"). Consumers do not consider alternative tobacco products to be close substitutes for cigarettes. Cigarette producers similarly view cigarettes and other tobacco products as separate product categories, and cigarette prices are not significantly constrained by other tobacco products.

The United States is the relevant geographic market in which to analyze the effects of the Acquisition on the cigarette market. Both Reynolds and Lorillard sell cigarettes primarily in this country. U.S. consumers are in practice limited to the set of current U.S. producers when seeking to buy cigarettes.

The U.S. cigarette market has experienced declining demand since 1981. Total shipments fell by approximately 3.2% in 2014, with similar annual declines expected in the future. The market includes three large producers—Altria, Reynolds, and Lorillard—who together account for roughly 90% of all cigarette sales. Two smaller producers —Liggett and Imperial—have roughly 3% market shares apiece. All other producers have individual market shares of 1% or less.

Competition in the U.S. cigarette market involves brand positioning, customer loyalty management, product promotion, and retail presence. Cigarette advertising is severely restricted in the United States: various forms of advertising and marketing are prohibited by law, by regulation, and by the terms of settlement agreements between major cigarette producers and the individual States. The predominant form of promotion remaining for U.S. cigarette producers is retail price reduction.

III. Entry

Entry or expansion in the U.S. cigarette market is unlikely to deter or counteract any anticompetitive effects of the proposed Acquisition. New entry in the cigarette market is difficult because of falling demand and the potentially slow and costly process of obtaining Food and Drug Administration clearance for new cigarette products. Expansion by new or existing cigarette producers is further obstructed by legal restrictions on advertising, limited retail product-visibility for fringe cigarette brands, and existing retail marketing contracts.

IV. Effects of the Acquisition

The proposed Acquisition is likely to substantially lessen competition in the U.S. cigarette market. It would eliminate current and emerging head-to-head competition between Reynolds and Lorillard, particularly for menthol cigarette sales, which is an increasingly important segment of the market. The Acquisition would also increase the likelihood that the merged firm will unilaterally exercise market power. Finally, the Acquisition will increase the likelihood of coordinated interaction between the remaining participants in the cigarette market.

V. The Consent Agreement

The purpose of the Consent Agreement is to mitigate the anticompetitive threat of the proposed acquisition. The Consent Agreement allows Reynolds to complete its acquisition of Lorillard, but requires Reynolds to divest several of its post-acquisition assets to Imperial.

Among other terms, the Consent Agreement requires Reynolds to sell Imperial four of its post-acquisition cigarette brands: Winton, Kool, Salem, and Maverick. These brands have a combined share of approximately 7% of the total U.S. cigarette market. Reynolds must also sell Lorillard's manufacturing facility and headquarters to Imperial, give Imperial employment rights for most of Lorillard's current staff and salesforce, and guarantee Imperial visible retail shelf-space for a period of five months following the close of the transaction. Finally, Reynolds must also provide Imperial with certain transition services.

This divestiture package, including the nationally recognized Winston and Kool brands, provides Imperial an opportunity to rapidly increase its competitive significance in the U.S. market. Imperial will shift immediately from being a small regional producer with limited competitive influence on the larger firms to become a national competitor with the third-largest cigarette business in the market. While Imperial's plans call for it to reposition the acquired brands, which have lost market share as part of the Reynolds portfolio, Imperial has successfully executed similar turnarounds with brands in other international markets.

Imperial will have greater opportunity and incentive to promote and grow sales of the divested brands because, unlike Reynolds, incremental sales of these brands are unlikely to cannibalize sales from more profitable cigarette brands in its portfolio. Imperial's incentive to reduce the price of the divestiture brands, in order to grow their market share, is a procompetitive offset to the reduction in competition that will result from the consolidation of Reynolds and Lorillard. Imperial's incentive to reduce prices and promote products in new areas likewise reduces the threat of anticompetitive coordination following the merger—as coordination on price increases and other aspects of competition may be relatively difficult given Imperial's contrary incentives. Ultimately, the divestiture package provides Imperial with a robust opportunity to undertake procompetitive actions to grow its market share in the U.S. cigarette market, and address the competitive concerns raised by the merger.

VI. Opportunity for Public Comment

By accepting the Consent Agreement, subject to final approval, the Commission anticipates that the competitive problems alleged in its Complaint will be resolved. The purpose of this analysis is to invite and facilitate public comment concerning the Consent Agreement to aid the Commission in determining whether it should make the Consent Agreement final. This analysis is not an official interpretation of the Consent Agreement, and does not modify its terms in any way.