

# Competition Policy Center

University of California, Berkeley

Working Paper No. CPC99-02

## **Mergers with Differentiated Products: The Case of Ready-to-Eat Cereal**

**Aviv Nevo**

University of California, Berkeley

November 1997

JEL Classification:

Keywords: Merger analysis, discrete choice models, random coefficients, product differentiation, ready-to-eat cereal industry

Abstract:

Traditional merger analysis, based on market definition and use of concentration measures to infer potential anti-competitive effects, is problematic and difficult to implement when evaluating mergers in industries with differentiated products. This paper discusses an alternative which consists of a front-end estimation of demand and back-end use of a model of post-merger conduct to simulate the competitive effects of a merger. I discuss and demonstrate the use of different methods of estimating demand. Furthermore, I show how the estimated demand parameters can be used to compute the post-merger price equilibrium (rather than just an approximation to it) and changes in welfare. The methodology is applied to two recent mergers and two hypothetical mergers in the ready-to-eat cereal industry. The results clearly demonstrate the importance of the model used in front-end estimation and the computation of equilibrium in determining the competitive effects of a merger.

---

This paper is based on various chapters of my 1997 Harvard University Ph. D. dissertation. Special thanks to my advisors, Gary Chamberlain, Zvi Griliches and Michael Whinston for guidance and support. I wish to thank Ronald Cotterill, the director of the Food Marketing Policy Center in the University of Connecticut, for sharing with me his data. I am grateful to Richard Gilbert for comments and suggestions. Financial support from the Graduate School Fellowship Fund at Harvard University and the Alfred P. Sloan Doctoral Dissertation Fellowship Fund is gratefully acknowledged. Address for correspondence, 549 Evans Hall#3880, Department of Economics, UC-Berkeley, Berkeley, CA 94720-3880, e-mail: [nevo@econ.berkeley.edu](mailto:nevo@econ.berkeley.edu)

This paper is available on-line at <http://www.haas.berkeley.edu/groups/cpc/pubs/Publications.html>

## 1. INTRODUCTION

Traditional policy towards analysis of mergers is primarily structural. Markets are defined, markets shares of the relevant firms are used to compute a concentration measure, which gives rise to presumptions of illegality. Using this approach to evaluate mergers in industries with differentiated, or closely related but not identical, products is problematic. In many cases the product offerings present a continuum, making a definite distinction between “inside” and “outside” goods impossible. Furthermore, even if a market can be defined the computed concentration index provides a reasonable standard by which to judge the competitive effects of the merger only if the products are equally spaced in some attribute space.

In order to deal with these challenges a new methodology to evaluate mergers has developed (see for example, Baker and Bresnahan, 1985; Hausman, Leonard and Zona, 1994; or Werden and Froeb, 1994). The basic idea consists of “front-end” estimation, in which demand for the products is estimated, and a “back-end” analysis, in which the demand elasticities are used to simulate the competitive effects of the merger. This paper presents this methodology and uses it to evaluate actual, and hypothetical, mergers in the ready-to-eat cereal industry. It contributes to the existing literature in several ways.

First, in the traditional merger analysis it is widely accepted that the market definition generally determines the outcome of the case. Equivalently, the outcome of the back-end simulation is largely determined by the front-end estimation of demand. Fortunately, the debate over the demand estimation can be based on science. Surprisingly, however, most of the discussion of the new methodology has focused on the back-end simulations rather than on the front-end estimation (see Werden, 1997). Using newly developed methods for estimating demand for differentiated products and aggregate point of sales scanner data I discuss and demonstrate the

different options for the front-end estimation. The empirical results clearly demonstrate the importance of the choice of estimation method.

Second, unlike previous work I demonstrate how estimates the demand function can be used to compute the post-merger equilibrium rather than an approximation to it. The results show that in some cases the approximation works well while in others the result is different from the true equilibrium outcome. Figuring out how well the approximation does is harder than computing the true predicted post-merger equilibrium.

Finally, the model presented here has the clear advantage over alternative methods in translating the changes in equilibrium prices to consumer well-being. The demand system is derived from indirect utility curves of heterogenous consumers and therefore the parameters can be used directly to simulate not the just the change in prices, but the change in consumers utility.

Estimation of demand has been a central concern of applied economists for several decades. In industries with differentiated products the task is much harder because of the large number of parameters to be estimated. To be more specific, suppose we have 200 differentiated products (as in the RTE cereal industry), then assuming constant elasticity demand curves implies estimating 40,000 price elasticities. Even if we impose restrictions implied by economic theory, the number of parameters will still be too high to estimate with any reasonable data set.<sup>2</sup>

One solution to this problem is given by the discrete choice literature (for example see McFadden, 1973, 1978, 1984; Cardell, 1989; Berry, 1994; Berry, Levinsohn and Pakes, 1995, or Nevo, 1997b). Here the dimensionality problem is solved by projecting the products onto a

---

<sup>2</sup>Note that in analysis of mergers we can restrict our attention to those products that are produced by the merging parties, which might be a smaller sub-set. This is the logic behind the analysis of Baker and Bresnahan (1985). In some cases, however, this sub-set might still be large.

space of characteristics, making the relevant dimension the dimension of this space and not the square of the number of products. Some of the models in this class are very restrictive in nature (for example the Logit or Antitrust Logit models) and should be used with caution in simulating mergers. The model used in this paper belongs to this class of models but is flexible and yields reasonable substitution patterns.

An alternative to discrete choice methods is given by Hausman, Leonard, and Zona (1994) and Hausman (1996), which demonstrate the use of a multilevel demand model to estimate demand for differentiated products. The essential idea is to use aggregation and separability assumptions to justify different levels of demand. The top level is the overall demand for the product category (for example RTE cereal). Intermediate levels of the demand system, model substitution between various market segments, for example, between kids cereals and natural cereals. The bottom level is the choice of a brand within a segment. Each level of the demand system can be estimated using a flexible functional form. This segmentation of the market reduces the number of parameters proportionally to the inverse of the number of segments. Therefore, with either a small number of brands or a large number of (a priori) reasonable segments this method can use flexible functional forms (for example the Almost Ideal Demand System of Deaton and Muellbauer, 1980a) to give good first order approximations to any demand system. However, as the number of brands in each segment increases, beyond a handful, this method becomes less feasible. Section 3 provides a comparison of the multilevel demand model and the method employed in this paper.

The rest of this paper is organized as follows. Section 2 describes the traditional merger analysis as it is described in the merger guidelines. Section 3 presents the new methodology for evaluating the effects of mergers. An emphasis is placed on the front-end estimation. The

methodology is applied to the ready-to-eat cereal industry and the results presented in Section 4. I conclude with a discussion in Section 5.

## **2. TRADITIONAL MERGER ANALYSIS AND THE MERGER GUIDELINES**

Section 7 of the Clayton Act states that a merger is prohibited if its likely effect will be “to substantially lessen competition.” The Merger Guidelines indicate the situations under which the Department of Justice is likely to challenge a merger, or acquisition, under section 7. The 1968 guidelines rely, almost exclusively, on measures of market concentration in order to accomplish this goal, without detailing how the relevant market should be measured.

In contrast, the 1982 and 1984 guidelines are more detailed, and attempt to rely on economic theory (see Willig, 1991). The process defines a set of discrete analytic steps. First, the relevant market is determined by establishing the smallest set of products for which a hypothetical monopolist would profitably impose a “small but significant and non-transitory increase in price” (abbreviated to SSNIP). A SSNIP is usually taken to be a 5% increase in price. In a merger by two parties this is done by first considering the products of the two firms, and then adding the products of their competitors until a set of products that imposes a SSNIP is found<sup>3</sup>.

The next step is to determine the potential “players” in this market. All firms that currently produce and sell in the market will be included, as will firms with potential production capabilities. How the latter is defined is not always clear. For each of these firms the market share of sales (or in some cases capacity) is determined. A measure of concentration is computed,

---

<sup>3</sup>See Werden (1992a), for a history of market delineation, and Werden (1992b) for some practical suggestions.

typically the Herfindahl-Hirschman Index (HHI)<sup>4</sup>. The general standards are that a horizontal merger will not be challenged if the post-merger HHI is below 1,000. If the post-merger HHI is between 1,000 and 1,800, mergers that increase the HHI by less than 100 points will usually not be challenged, and otherwise the decision will be based on a variety of other considerations. When the post-merger is over 1,800 a 50 points increase will be the threshold for challenging a merger. Finally, additional factors, such as entry or increased production efficiency, are considered (see Willig, 1991, for details).

The logic behind these standards is that a merger in an unconcentrated industry, or a merger that raises concentration only slightly, is not likely to have anti-competitive effects. There is no attempt, in the 1984 guidelines, to quantify the mechanism through which these effects occur. For the analysis of competition in differentiated products this process is somewhat problematic. Willig (1991, pg. 299-305) notes that if demand follows the restrictive Logit model, then relying solely on market shares, to determine merger policy, is sensible. But this is no surprise; in the Logit model all substitutions patterns are determined solely by the market shares. I will claim below, and empirically demonstrate, that for the ready-to-eat cereal industry a Logit model of demand is inadequate and can lead to the “wrong” conclusions. Therefore, in analyzing mergers in a differentiated products industry, like the cereal industry, the traditional structural approach does not stand on sound ground.

The applications of the traditional structural approach, as the approach previously described has been termed, to differentiated products is problematic not only from the theoretical view. Due to consumer heterogeneity it is easy to argue that many products should be included in

---

<sup>4</sup> The HHI is the sum of the squares of market shares, which are measured in percentage, and therefore will vary between 0 and 10,000. For an axiomatic treatment of this index see Encaoua and Jacquemin (1980).

the relevant market. For example, when examining ready-to-eat cereal one might claim that hot cereal and bagels are “close” substitutes, at least for some consumers, and should therefore be included in the relevant market. The result is that the market can be defined broadly and the resulting market shares are small.

The 1992 Horizontal Merger Guidelines have made improvements in the analysis of the competitive effects of mergers. A separate discussion is dedicated to unilateral effects (i.e., effects not involving collusion) of mergers in differentiated products industries. Shapiro (1996, pg. 24) summarizes the implementation of the guidelines:

- “(1) Consider a price increase for brand A of, say, 10%. Try to measure what fraction of the sales lost by brand A due to the price increase would be captured by brand B. I call this fraction the Diversion Ratio (from Brand A to Brand B).
- (2) Based on pre-merger Gross Margins and the estimated Diversion Ratio, calculate the post-merger price increase, assuming no synergies or rival supply responses.
- (3) Try to account for any likely and timely changes in prices or product offerings by non-merging parties, including product repositioning and entry.
- (4) If there are credible and documented synergies that lower marginal costs, reduce the predicted post-merger prices accordingly.”

In practice the Guidelines’ facilitated a methodology of using estimated own and cross-price elasticities in analyzing mergers<sup>5</sup>.

The use of econometric estimates in merger analysis has gone an additional step forward

---

<sup>5</sup> For example, in the case of New York vs. Kraft General Foods, Inc. both sides used estimates of demand elasticities.

by using not just the raw estimates (or a diversion ratio), rather the price increases that would result from the merger are computed. Typically, this will involve computing an approximation to the price increase for the products of the merging firms.<sup>6</sup> Typically, such a practice is justified by a so called, Nash-Bertrand assumption. However, the predicted post-merger prices are not the new equilibrium prices. The next section shows not only how the post-merger equilibrium can be computed, but also how the simulations can be translated into change in consumer well-being.

### **3. SIMULATING THE EFFECTS OF A MERGER**

The general strategy in simulating a merger in a differentiated products industry consists of several steps. First, elasticities of demand are estimated. Second, marginal costs are recovered either by estimation (potentially jointly with the demand parameters in the first step) or by using the estimated demand elasticities and assuming a model of pre-merger pricing conduct. Third, the new price equilibrium is computed using estimated demand and marginal costs, and assuming a model of post-merger pricing conduct. Finally, effects of the merger on non-price competition are taken into account.

#### *3.1 Step 1: Estimating Demand for Differentiated Products*

The first step in computing the effects of a merger, sometimes called the front-end, is estimating demand. This step is not only the most difficult, from an econometric view point, but also is important in determining the outcome of the next several steps. Its importance parallels that of the market definition in the traditional merger analysis. Different methods are surveyed below, and some are applied to data in the next section. Issues regarding the actual estimation,

---

<sup>6</sup>See Hausman, Leonard, and Zona (1994) or Werden and Froeb (1994).

data requirements and an empirical comparison between these methods is beyond the scope of this paper. The interested reader is referred to Nevo (1997a, 1997c) for a careful discussion of all these empirical issues.

### *The Problem*

Probably the most straight-forward approach to estimating a demand system is to specify a system of demand equations

$$q = D(p; r)$$

where  $q$  is a  $J$ -dimensional vector of quantities demanded from the  $J$  commodities,  $p$  is a  $J$ -dimensional vector of prices of the commodities, and  $r$  is a vector of exogenous variables that shift demand. The main concern of previous work was to specify  $D(\cdot)$  in a way that was both flexible and consistent with economic theory. Such methods include: the Linear Expenditure model (Stone 1954), the Rotterdam model (Theil, 1965; and Barten 1966), the Translog model (Christensen, Jorgenson, and Lau, 1975), and the Almost Ideal Demand System (Deaton and Muellbauer, 1980a).

The problem in applying any of these methods to estimate demand for differentiated products is the dimensionality problem. Due to the large number of products, even if we were to assume a very simple and restrictive functional form for the demand function,  $D(\cdot)$ , the number of parameters will be too large to estimate. For example, a linear demand system,  $D(p) = Ap$ , where  $A$  is  $J \times J$  matrix of constants, implies  $J^2$  parameters. The number of parameters can be reduced by imposing symmetry of the Slutsky matrix and adding up restrictions. However, the basic problem still remains: the number of parameters to be estimated increases with square the number of products. This problem is augmented if we attempt to use a flexible functional form.

## Solutions

Solutions to the problem, discussed above, include: (1) symmetric representative consumer models, (2) multi-stage budgeting and (3) discrete choice/address models. This section presents these methods and shows how they solve the dimensionality problem.

### 3.1.1 Symmetric Representative Consumer Models

A widely used specification in theoretical models of product differentiation is the constant elasticity of substitution (CES) utility function used by Dixit and Stiglitz (1977) and Spence (1976). The CES utility function takes the form

$$U(q_1, \dots, q_J) = \left( \sum_{i=1}^J q_i^\rho \right)^{1/\rho},$$

where  $\rho$  is a constant parameter that measures substitution across products. The demand of the representative consumer obtained from this utility function is

$$q_k = \frac{p_k^{-1/(1-\rho)}}{\sum_{i=1}^J p_i^{-\rho/(1-\rho)}} I, \quad k = 1, \dots, J,$$

where  $I$  is the income of the representative consumer. The dimensionality problem is solved by imposing symmetry between the different products; thus, estimation involves a single parameter, regardless of the number of products, and can be achieved using non-linear estimation methods.

However, the symmetry condition is restrictive and indeed for this model implies

$$\frac{\partial q_i}{\partial p_j} \frac{p_j}{q_i} = \frac{\partial q_k}{\partial p_j} \frac{p_j}{q_k}, \text{ for all } i, k, j.$$

The cross-price elasticities are restricted to be equal, regardless of how “close” the products are in some attribute space. This restriction can have important implications for the simulation of mergers and in many cases would lead to the “wrong” conclusions.

An alternative to the CES utility function is

$$U(q_1, \dots, q_J) = \sum_{i=1}^J a_i q_i - \sum_{i=1}^J q_i \ln q_i ,$$

which as shown by Anderson, de Palma, and Thisse (1992) yields the Logit demand. Estimation of this model involves  $J$  parameters and allows for somewhat richer substitution patterns.

However, as discussed below the substitution patterns in the Logit model are solely a function of market shares (which here are equivalent to the quantities consumed by the aggregate consumer), and are not related to the characteristics of the products. Or in other words, due to the aggregate IIA property if the price of commodity  $i$  increases the representative consumer will keep the same ratio  $q_j/q_k$ , for all  $j, k \neq i$ , instead of consuming relatively more of products that are similar to product  $i$ .

The utility function for the Logit representative consumer has two terms. The first suggests that the representative consumer will consume only the product with the highest  $a_j$ .<sup>7</sup> The second term is an entropy term and expresses a variety-seeking behavior.<sup>8</sup> Through this second term we get consumption of more than one product, but its functional form illuminates the similarity between the aggregate IIA property and the symmetry condition embodied in the CES utility: all products enter this entropy term in a symmetric way.

In summary, models of this class solve the dimensionality problem by imposing symmetry conditions which implicitly suggest an extreme form of non-localized competition. Although for

---

<sup>7</sup>Note, that here  $a_j$  is equivalent to  $\delta_j$ , using the notation of Section 3.1.3.

<sup>8</sup>In the theoretical literature (for example, Anderson, de Palma, and Thisse, 1992) this term will be multiplied by a positive parameter that captures the relative importance of the variety-seeking behavior. As this parameter goes to zero variety is not valued and one product is purchased by the representative consumer (i.e., there is no heterogeneity in the population); while as this parameter goes to infinity consumption is divided equally among all the products. I follow here the empirical literature that, for identification reasons, normalizes this parameter to one.

some industries this model of differentiation is adequate, for most markets this is not the case.

### 3.1.2 *Separability and Multi-Stage Budgeting*

A different approach to solving the dimensionality problem is to divide the products into smaller groups and allow for a flexible functional form within each group. The justification of such a procedure relies on two closely related ideas: the separability of preferences and multi-stage budgeting.

The first notion is that of (weak) separability of preferences. If this holds commodities can be partitioned into groups so that preferences within each group are independent of the quantities in other groups. For example, the utility function can be written as

$$U(q_1, q_2, \dots, q_J) = f[v_1(q_1, q_2), v_2(q_3, q_4), \dots, v_G(q_{J-1}, \dots, q_J)],$$

where  $f(\cdot)$  is some increasing function and  $v_1, \dots, v_G$  are the sub-utility functions associated with the separate groups. The groups could be broad categories such as food, shelter and entertainment, and each group can possibly be divided into one or more sub-grouping.

A slightly different notion is that of multi-stage budgeting. This occurs when the consumer can allocate total expenditure in stages; at the highest stage expenditure is allocated to broad groups, while at lower stages group expenditure is allocated to sub-groups, until expenditures are allocated to individual products. At each stage the allocation decision is a function of only that group total expenditure and prices of commodities in that group (or price indexes for the sub-groupings). All these allocations must equal those that would occur if the maximization was done in one complete information step.

The two notions, of weak separability and multi-stage budgeting, are closely related; however, they are not identical, nor does one imply the other. Weak separability is necessary and sufficient for the last stage of the multi-stage budgeting; if a subset of products appears only in a

separable sub-utility function, then the quantities demanded of these products can always be written as only a function of group expenditures and prices of other products within the group. The higher stages, the allocation of expenditures between groups, are more problematic and have to rely on the composite commodity theorem (Hicks, 1936; or Leontief, 1936), on various restrictions on preferences, or on stronger notions of separability (see Gorman, 1959; or Deaton and Muellbauer, 1980b chapter 5). From an empirical point of view the most useful of these theorems is the requirement (1) that the indirect utility functions for each segment are of the Generalized Gorman Polar Form, and (2) that the overall utility is separable additive in the sub-utilities.

Originally, these methods were developed for the estimation of fairly broad categories of products. Hausman, Leonard, and Zona (1994) and Hausman (1996) use the idea of multi-stage budgeting to construct a multi-level demand system for differentiated products. The actual application involves a three stage system: the top level corresponds to overall demand for the product (beer or ready-to-eat cereal, in their applications); the middle level involves demand for different market segments (for example, family, kids and adults cereal); and the bottom level involves a flexible brand demand system corresponding to the competition between the different brands within each segment.

For each of these stages a flexible parametric functional form is assumed. The choice of functional form is driven by the need for flexibility, but also requires that the conditions for multi-stage budgeting are met. A typical application has the AIDS model (see Deaton and Muellbauer, 1980a) at the lowest level: the demand for brand  $i$  within segment  $g$  in city  $c$  at quarter  $t$  is

$$s_{jct} = \alpha_{jc} + \beta_j \log(y_{gct}/P_{gct}) + \sum_{k=1}^J \gamma_{jk} \log p_{kct} + \varepsilon_{ict}, \quad (1)$$

$$j = 1, \dots, J, \quad c = 1, \dots, C, \quad t = 1, \dots, T,$$

where  $s_{jct}$  is the dollar sales share of total segment expenditure,  $y_{gct}$  is overall per capita segment expenditure,  $P_{gct}$  is the price index and  $p_{kct}$  is the price of the  $k$ th brand in city  $c$  at quarter  $t$ . This system defines a flexible functional form that can allow for a wide variety of substitution patterns within the segment. It has two additional advantages over other flexible demand systems (like the Rotterdam system or the Translog model): (1) it aggregates well over individuals; and (2) it is easy to impose (or test) theoretical restrictions, like adding-up, homogeneity of degree zero and symmetry (for details see Deaton and Muellbauer, 1980a).

The price index,  $P_{gct}$ , is computed as either the Stone logarithmic price index

$$P_{gct} = \sum_{k \in g} s_{kct} \log p_{kct}, \quad (2)$$

or the Deaton and Muellbauer exact price index

$$P_{gct} = \alpha_0 + \sum_{k \in g} \alpha_k p_k + \frac{1}{2} \sum_{j \in g} \sum_{k \in g} \gamma_{kj} \log p_k \log p_j. \quad (3)$$

The exact form of the price index does not seem to be very important for the results (see Deaton and Muellbauer, 1980a pg 316-317). If the latter is used the estimation is non-linear, while with the Stone index the estimation can be performed using linear methods.

The middle level of demand captures the allocation between segments and can be modeled using the AIDS model, in which case the demand specified by equation (1) is used with both expenditure shares and prices aggregated to a segment level (the prices are aggregated using either equations (2) or (3)). An alternative is the log-log equation used by Hausman, Leonard, and Zona (1994) and Hausman (1996):

$$\log q_{gct} = \beta_g \log y_{Rct} + \sum_{k=1}^G \delta_k \log \pi_{kct} + \alpha_{gc} + \varepsilon_{gct};$$

$$g = 1, \dots, G, \quad c = 1, \dots, C, \quad t = 1, \dots, T,$$

where  $q_{gct}$  is the quantity of the  $g$ th segment in city  $c$  at quarter  $t$ ,  $y_{Rct}$  is total ready-to-eat cereal expenditure, and  $\pi_{kct}$  are the segment price indexes (computed using either equations (2) or (3)).

Since the lower level of the demand system is the AIDS, which satisfies the Generalized Gorman Polar Form (GGPF), the preferences of the second level should be additively separable (i.e., overall utility from ready-to-eat cereal should be additively separable in the sub-utilities from the various segments), in order to be consistent with exact two-stage budgeting.<sup>9</sup> Neither the second level AIDS, nor the log-log system satisfy this requirement. Also, in order for exact multi-stage budgeting to hold to the next level of aggregation these preferences should be of the GGPF.

Finally, at the top level the demand for the whole ready-to-eat cereal category is specified as

$$\log q_{ct} = \beta_0 + \beta_1 \log y_{ct} + \beta_2 \log \pi_{ct} + Z_{ct} \delta + \varepsilon_{ct}$$

where  $q_{ct}$  is the overall consumption of cereal in city  $c$  at quarter  $t$ ,  $y_{ct}$  is real income,  $\pi_{ct}$  is the price index for cereal and  $Z_{ct}$  are variables that shift demand (demographics and time factors).

We note that this does satisfy additive separability, which is required for exact two-stage budgeting.

### 3.1.3 Discrete Choice Models

The last class of models that solve the dimensionality problem are discrete choice models,

---

<sup>9</sup>Instead of using the notion of exact two-stage budgeting one can rely of approximate two-stage budgeting. Deaton and Muellbauer (1980b, pg. 132-133) show that for the Rotterdam model approximate two-stage budgeting implies that the higher stages also have a Rotterdam functional form, but require two price indexes to sum the price in each group. They claim that in practice these indexes are collinear and therefore can be treated as one. I do not know of any such derivation to justify this practice with the AIDS.

which model products as bundles of characteristics. Preferences are defined over the characteristics space, making the dimension of this space the relevant dimension for empirical work.

I focus on a particular specification which includes, with small changes, most of the specifications used in previous work. In this specification, the conditional indirect utility of consumer  $i$  from product  $j$  in market  $t$  is<sup>10</sup>

$$u_{ijt} = x_{jt}\beta_i^* - \alpha_i^* p_{jt} + \xi_j + \Delta\xi_{jt} + \varepsilon_{ijt}, \quad (4)$$

$$i=1,\dots,I_t \quad j=1,\dots,J, \quad t=1,\dots,T$$

where  $x_{jt}$  is a  $K$ -dimensional vector of observable characteristics of product  $j$ ,  $p_{jt}$  is the price of product  $j$  in market  $t$ ,  $\xi_j$  is the national mean of the unobserved (by the econometrician) product characteristics,  $\Delta\xi_{jt}$  is a market specific deviation from this mean, and  $\varepsilon_{ijt}$  is a mean zero stochastic term. Finally,  $(\alpha_i^* \beta_i^*)$  are  $K+1$  individual specific coefficients.

The distribution of consumer taste parameters is a function of individual characteristics, which consist of demographics that are observed and additional characteristics that are unobserved, denoted  $D_i$  and  $v_i$  respectively. I model the distribution of consumers taste parameters for the characteristics as multi-variate normal (conditional on demographics) with a mean that is a function of demographic variables and parameters to be estimated, and a variance-covariance matrix to be estimated. Let  $\gamma_i^* = (\alpha_i^*, \beta_{i1}^*, \dots, \beta_{iK}^*)$  and  $\gamma = (\alpha, \beta_1, \dots, \beta_K)$  where  $K$  is the dimension of the observed characteristics vector; therefore,

$$\gamma_i^* = \gamma + \Pi D_i + \Sigma v_i, \quad v_i \sim N(0, I_{K+1}), \quad (5)$$

where  $D_i$  is a  $d \times 1$  vector of demographic variables,  $\Pi$  is a  $(K+1) \times d$  matrix of coefficients that

---

<sup>10</sup>The methods discussed here are general and with minor adjustments can deal with different functional forms.

measure how the taste characteristics vary with demographics, and  $\Sigma$  is a scaling matrix.<sup>11</sup>

The specification of the demand system is completed with the introduction of an "outside good"; the consumers may decide not to purchase any of the brands. Without this allowance a homogenous price increase (relative to other sectors) of all the products does not change quantities purchased. The indirect utility from this outside option is

$$u_{i0t} = \xi_0 + \pi_0 D_i + \sigma_0 v_{i0} + \varepsilon_{i0t} .$$

The mean utility of the outside good is not identified (without either making more assumptions or normalizing one of the "inside" goods); thus, I normalize  $\xi_0$  to zero.

In order to estimate the parameters of the model assumptions regarding the distribution of the unobserved variables are required. Once these assumptions are made, the model can be estimated using individual purchasing data or aggregate market data, which is more widely available (for details of the estimation see the Appendix).

Possibly the simplest distributional assumptions one can make are those made in classical discrete choice models: consumer heterogeneity enters the model only through the separable additive random shock,  $\varepsilon_{ijt}$ . In our model this implies  $\beta_{ij}^* = \beta_j$ ,  $\alpha_i^* = \alpha$  for all  $i$ , and equation (4) becomes

$$u_{ijt} = x_{jt} \beta - \alpha p_{jt} + \xi_j + \Delta \xi_{jt} + \varepsilon_{ijt}, \quad i=1, \dots, I_t \quad j=1, \dots, J, \quad t=1, \dots, T. \quad (6)$$

If  $\varepsilon_{ijt}$  is distributed i.i.d. with a Type I extreme value distribution, this is the well-known (Multinomial) Logit model.

The Logit model is appealing, due to its tractability, however it restricts the price elasticities of demand in two ways. First, a problem which has been stressed in the literature is with the cross-price elasticities. When a price of a brand increases the Logit model restricts

---

<sup>11</sup>Alternatively, one could think of a composite "error" term,  $v_i^*$ , which is distributed  $N(0, \Sigma^*)$  and  $\Sigma$  is the Cholesky factorization of  $\Sigma^*$ .

consumers to substitute towards other brands in proportion to market shares, regardless of characteristics. In the context of RTE cereals this implies that if, for example, Quaker CapN Crunch (a kids cereal) and Post Grape Nuts (a wholesome simple nutrition cereal) have similar market shares, then the substitution from General Mills Lucky Charms (a kids cereal) toward either of them will be the same. Intuitively, if the price of one kids cereal goes up we would expect more consumers to substitute to another kids cereal than to a nutrition cereal.

An additional problem, that has received less attention, is that without allowing for heterogeneity in the consumer price sensitivity own-price elasticities are determined by functional form. If the price enters in a linear form, and the market share of most products is small, then own-price elasticities will be almost exactly proportional to own price. Therefore, the lower the price the lower the elasticity (in absolute value), which implies that a standard pricing model predicts a higher markup for the lower-priced brands. This is possible only if the marginal cost of a cheaper brand is lower (not just in absolute value, but as a percentage of price) than that of a more expensive product. For some products this will not be true. If, for example, price enters in log form the implied elasticity would be roughly constant. In other words, the functional form directly determines the patterns of own-price elasticity.

The Nested Logit (McFadden, 1978) is a slightly more complex model in which the i.i.d. extreme value assumption is replaced with a variance components structure. All brands are grouped into exhaustive and mutually exclusive sets. A consumer has a common shock to all the products in a set, so she is more likely to substitute to other products in the group.

The Nested Logit model allows for somewhat more flexible substitution patterns, yet retains the computational simplicity of the Logit structure. In many cases the a priori division of products into groups, and the assumption of i.i.d. shocks within a group, will not be reasonable

either because the division of segments is not clear or because the segmentation does not fully account for the substitution patterns. Furthermore, the Nested Logit model does not help with the problem of own-price elasticities. This is usually handled by assuming some "nice" functional form, yet does not solve the problem of having the elasticities be driven by the functional form assumption.

If in the full model, described by equations (4) and (5), we maintain the i.i.d. extreme value distribution assumption. Now own-price elasticity will not necessarily be driven by functional form: each individual will have a different price sensitivity, which will be averaged to a mean price sensitivity using the individual specific probabilities of purchase as weights. The price sensitivity will be different for different brands. Furthermore, the full model also allows for flexible substitution patterns, which will be guided by the product characteristics. Consumers that stop purchasing a brand due to a price increase are more likely to switch to products with similar characteristics rather than just proportionally to market shares. By allowing one of the characteristics to be the market segment of the brand, this model can take advantage of a priori segmentation of the market in a diffuse manner.

Unfortunately, these advantages do not come without cost. Estimation of the full model is not as simple as that of the Logit or Nested Logit models (see the Appendix).

### *Comparing the Different Methods*

In general the symmetric average consumer models are the least adequate for simulating the effects of a merger. The main weakness of these methods is in estimating the "closeness" of the various products, which is the key measure for the analysis of a merger. Despite this problem the Logit model has been used frequently for merger analysis due to its tractability and ease of

use (see Werden and Froeb, 1994). Unless time is a binding constraint these models should not be used.

Choosing between the multi-stage budgeting approach and the random coefficients discrete choice method is harder. Both have advantages and weakness compared to each other. The multi-level model requires a priori segmentation of the market into relatively small groups, which in some cases might be hard to define. Second, as mentioned above the empirical specification does not always meet the theoretical requirements. Also, the derivation of the AIDS assumes that there no corner solutions, i.e., all consumers consume all products. When dealing with broad categories like food and shelter, as in the original model of Deaton and Muellbuer (1980a), this is a reasonable assumption. For differentiated products, however, it is rather unlikely that all consumers consume all varieties. Finally, from the applied estimation point of view it is harder to find exogenous instrumental variables, which explain the results found in Nevo (1997a, Chapter 6).

On the plus side this method has two clear advantages. First, it is closer to classical estimation methods and neo-classical theory, and therefore is easier and more intuitive to understand. An additional point, important for practitioners, is that the computation time is lower.

Discrete choice models require characteristics of products, in general are more computational intense, and rely on distributional assumptions and functional forms. All these problems are treated by innovations introduced in Nevo (1997b), and used below. The latter difficulty requires careful sensitivity analysis, which should not be a problem for careful scientific work but might be a problem for analysis of mergers under time constraints. A full empirical comparison of these two models is beyond the scope of his paper. The interested reader

is referred to Nevo (1997a, Chapter 6).

### 3.2 Step 2: Recovering Marginal Costs

In some rare cases marginal costs will be observed but in the typical case marginal costs need to be recovered. There are essentially two ways this can be done. First, is to use the estimated demand elasticities and a model of conduct in order to compute the marginal costs. Alternatively, the model of conduct could be estimated jointly with the marginal costs. I discuss both cases.

For simplicity of exposition I focus on a particular model of supply. The analysis can be generalized or changed to match the specifics of the market being considered. Formally, suppose there are  $F$  firms, each of which produces some subset,  $\mathcal{F}_f$ , of the  $j=1, \dots, J$  different brands. The profits of firm  $f$  are

$$\Pi_f = \sum_{j \in \mathcal{F}_f} (p_j - mc_j) M s_j(p) - C_f,$$

where  $s_j(p)$  is the market share of brand  $j$ , which is a function of the prices of all brands,  $M$  is the size of the market, and  $C_f$  are the fixed cost of production. The market size defined here is different than the one used in the standard analysis of mergers: it includes the share of the "outside good". This definition allows us to keep the market size fixed while still allowing the total quantity of products sold to increase (since such an increase will result in a decrease in the share of the outside good).

Assuming: (1) the existence of a pure-strategy Bertrand-Nash equilibrium in prices; and (2) that the prices that support it are strictly positive; the price  $p_j$  of any product  $j$  produced by firm  $f$  must satisfy the first order condition

$$s_j(p) + \sum_{r \in \mathcal{F}_f} (p_r - mc_r) \frac{\partial s_r(p)}{\partial p_j} = 0.$$

These set of  $J$  equations imply price-costs margins for each good. The markups can be solved for explicitly by defining

$$\Omega_{jr}(p) = \begin{cases} -\partial s_j(p) / \partial p_r, & \text{if } \exists f: \{r, j\} \subset \mathcal{F}_f; \\ 0, & \text{otherwise.} \end{cases} \quad (7)$$

In vector notation the first order conditions become

$$s(p) - \Omega(p)(p - mc) = 0.$$

This implies a markup equation

$$p - mc = \Omega(p)^{-1} s(p);$$

or that estimated marginal costs are

$$mc = p - \Omega(p)^{-1} s(p). \quad (8)$$

Equation (8) can be used in one of two ways. First, the estimates of the demand system obtained in Step 1 can be plugged into equation (7) and used to compute the implied marginal costs using equation (8). Alternatively, one could define the elements of the  $\Omega$  matrix as

$$\Omega_{jr}(p) = \theta_{jr} \frac{-\partial s_j(p)}{\partial p_r}, \quad 0 \leq \theta_{jr} \leq 1 \quad \forall j, r \quad (9)$$

The parameters  $\theta_{jr}$  can be interpreted as conjectural variation parameters. Note that the definition given in equation (7) is a private case of the definition given in equation (9). The extra parameters in the latter equation can in principal be estimated jointly with the demand parameters and possibly parameters that vary the marginal costs. This estimation requires either a measure of marginal costs or a specification of the variables that change these costs and a functional form assumption. In practice this estimation might be difficult to implement (see Nevo, 1997d).

### 3.3 Step 3: The Post-Merger Equilibrium

The final step is simulating the effects of the merger by computing the new equilibrium. From a technical point of view this is the simplest part of the exercise, yet from the economic point of view this is the hardest since it requires assumptions on various effects of the merger. In most cases the assumptions can be restricted to placing bounds on the possible variables (rather than committing to a particular value) and thus obtaining bounds on the effects.

In order to simulate the new price equilibrium a model of post-merger price conduct is required. Here I assume the same model as the pre-merger conduct model specified in the previous section. The analysis is not constraint to having the same model, nor is it restricted to the one presented here. Let  $\Omega_{post}$  be a matrix defined by using the demand estimates of Step 1 and the definition given in equation (7) using the post-merger structure of the industry, or the one given by equation (9) using the estimated CV parameters with adjustments for the change of ownership. Therefore, the predicted post-merger equilibrium price,  $p^*$ , solves

$$p^* = \hat{m}c + \Omega_{post}(p^*)^{-1} s(p^*), \quad (10)$$

where  $\hat{m}c$  are the marginal costs predicted in Step 2, and  $p^*$  is the vector of post-merger predicted equilibrium prices.

Note, that  $\Omega_{pre}$  and  $\Omega_{post}$  use the same demand estimates and differ only in the ownership structure. This does not imply that pre and post merger price elasticities are the same (since elasticity might vary with price); however, it is not consistent with the firms changing their optimal strategy in other dimensions that influence demand. For example, if as a result of the merger the optimal level of advertising changes, and advertising influences  $\partial s / \partial p$ , then the estimate of the equilibrium price, using equation (10) will be wrong. If one is willing to model advertising, then the post-merger equilibrium levels of prices and advertising can be predicted

jointly, using the first order conditions for both the decision variables and the same approach as above.

An alternative to finding the price that solves the system of equations (10) is to use an approximation used by previous work<sup>12</sup>

$$p^{approx} = \hat{m}\hat{c} + \Omega_{post}^{-1}S, \quad (11)$$

where  $S$  are the pre-merger observed market shares. Note that neither the market shares nor the partial derivatives of demand are a function of prices. Therefore, the prices defined by equation (11) are only an approximation to the true predicted post-merger equilibrium prices given by equation (10). In principal, one could analytically characterize the relation between the two vectors of prices, but in most cases computing the equilibrium prices is a standard problem of solving a system of non-linear equations and can be easily achieved using standard software.<sup>13</sup>

An additional shortcoming of previous simulations of mergers is that no attempt was made at translating the predicted changes in prices into a welfare measure. A measure of a consumer's welfare is given by consumer surplus, or the area under each consumer's demand curve.

Trajtenberg (1989) shows that in the discrete choice model presented above, for each consumer the consumer surplus is

$$CS_i = \frac{\ln\left\{1 + \sum_{j=1}^J \exp[x_{jt}\beta_i^* - \alpha_i^* p_{jt} + \xi_j + \Delta\xi_{jt}]\right\}}{\alpha_i}. \quad (12)$$

The total change in consumer welfare is obtained by aggregating over all the different consumers the difference in consumer welfare.

---

<sup>12</sup>For example see Hausman, Leonard and Zona (1994 equation 8); or Werden (1997 equation 1).

<sup>13</sup>For the results presented below I solved  $\Omega_{post}(p^*) * (p^* - \hat{m}\hat{c}) = s(p^*)$ , using the MATLAB standard algorithm for solving non-linear equations (fsolve.m). This computation usually took several seconds on a PentiumPro 200. Much faster algorithms can easily be found if required.

Modeling additional strategies used by firms, and estimating the implied policy functions, is problematic if these strategies have long-run implications. For example, suppose there is an investment a firm can undertake today (e.g., introducing a new brand) that improves its competitive position in the future. The optimal investment decision is obtained from solving the dynamic optimization problem of the firm. Like the short-run, static, decisions, in most oligopoly situations this optimal decision will be different with or without a merger. In the long-run, dynamic, case the difficulty is in estimating the parameters that influence this decision. Pakes and McGuire (1994) provide a strategy for computing a class of dynamic models that incorporate investment together with entry and exit. Estimation and simulation based on such models is the focus of ongoing work.

#### **4. AN APPLICATION TO MERGERS IN THE CEREAL INDUSTRY**

This section simulates the price changes that would result from mergers in the ready-to eat cereal industry. Four mergers are examined; two are actual mergers, and two are hypothetical. First, I analyze General Foods' acquisition of the Nabisco cereal line (General Foods also owns Post), and General Mills' acquisition of Chex. Next, I simulate hypothetical mergers between Quaker Oats and Kellogg, and Quaker Oats and General Mills. The choice of these two is by no means suggestive and is meant only to demonstrate the model of the previous section.

The ready-to-eat cereal industry is characterized by high concentration, high price-cost margins, large advertising to sales ratios and aggressive introduction of new products. For the purposes of our analysis the most important feature of this industry is the high concentration on the firm level. Tables 1a-b display the market shares of the main players in this industry.

Concentration on the brand level is lower. The top brands (General Mills Cheerios, Kellogg's

Corn Flakes and Frosted Flakes) will have a 5 percent market share and the smaller brands of the list presented in Table 2 will have roughly a 1 percent market shares. A full description of this industry is beyond the scope of this paper and can be found in Nevo (1997a chapter 1).

#### *4.1 Estimation of Demand*

The first step of the analysis described in the previous section is estimation of demand. Models from all the three classes described in Section 3.1 were explored, for reasons discussed below only two are presented here. The data and details of the estimation are described in the Appendix. The main results for these models are discussed below.

For each model the demand for 24 brands of cereal in 45 cities over 20 quarters was estimated. The set of products is presented in Table 2. For the purposes of this chapter, the portfolio of a company will consist only of the products in this set. Thus, a merger between Post and Nabisco is actually a merger between Post Raisin Bran, Post Grape Nuts and Nabisco Shredded Wheat. Synergies with, and between, the other products of the two companies is ignored. I will discuss the importance of this assumption in each case.

#### *Logit Demand*

The first model explored is the Logit model, described by equation (6). This is a discrete choice model but as was pointed out in Section 3 it can be viewed as a symmetric representative consumer model. The main reason for exploring this model is the emphasis it has received in the merger literature (see Werden and Froeb1994).

Table 3 presents results obtained by regressing the difference of the log of each brand's observed market share and the log of the share of the outside good,  $\ln(S_{jt}) - \ln(S_{ot})$ , on price, advertising expenditures, brand and time dummy variables. Column (i) displays the results of ordinary least squares regression. The coefficient on price and the implied own price elasticities

are relatively low. Since the Logit demand structure does not impose a constant elasticity, the estimates imply a different elasticity for each brand-city-quarter combination. Some statistics of the distribution of the elasticities are shown in the bottom of the column. The low elasticities and the high number of inelastic demands are not uncommon and are due to the endogeneity of prices discussed in the Appendix.

In order to deal with this endogeneity two sets of instrumental variables were explored. Columns (ii) and (iv) present two stage least squares estimates using average regional prices as instrumental variables. These IV are valid under the assumptions given in the Appendix. Columns (iii) and (v) use proxies for marginal costs as IV in the same regression. Finally, column (vi) uses both sets of IV. Columns (iv)-(vi) include controls for market demographics.

Three conclusions should be drawn from the results in Table 3. First, once IV are used the coefficient on price and the implied own-price elasticity increase, in absolute value. This is predicted by theory and holds in a wide variety of studies. Second, there are reasons to doubt the validity of the IV used to generate the results (see the Appendix for a discussion). The important thing to take from these results is the similarity between estimates using the two sets of IV. The similarity between the coefficients does not promise the two sets of IV will produce identical coefficients in different models or that these are valid IV, but it does give us some hope. Finally, the results demonstrate the importance of controlling for demographics and heterogeneity, which the full model presented below does.

Due to space limitations I limit my discussion to two implications of these results. The implied marginal costs are presented and discussed below. Table 4 presents the implied estimates of own- and cross-price elasticities. There are two disturbing patterns in this table, both predicted by theory and both due to the Logit functional form. First, the own price elasticities, presented in

the second column, are almost exactly linear in price. This is due to the lack of heterogeneity in the price coefficient and the fact that price enters in a linear form.<sup>14</sup> Second, the cross price elasticities are forced to be equal, and for this reason we need only present one number for each brand. This is probably the main limitation of using the Logit model for merger analysis. The implications of these constraints are discussed below.

### *Random Coefficients Discrete Choice Demand*

Estimation of the random coefficients discrete choice model of demand, described by equations (4) and (5), was performed using the same instrumental variables as in the previous section. The details of the estimation are given in the Appendix. The results of the estimation are presented in Table 5. The first column displays the means of the taste parameters,  $\alpha$  and  $\beta$ . Coefficients on price and advertising are estimated with a GMM procedure, while the coefficients on the physical characteristics come from a Minimum Distance regression of the GMM brand dummy coefficients on product characteristics. The next five columns present the parameters that measure heterogeneity in the population: standard deviations, interaction with log of income, log of income squared, log of age, and a dummy variable that is equal to one if age is under eighteen.

The means of the distribution of marginal utilities,  $\beta$ 's, are estimated by a Minimum Distance procedure (see Appendix for details). Except for *All-Family* segment dummy variable, all coefficients are statistically significant. For the average consumer, sugar has positive marginal utility, while a "mushy" cereal and fiber have negative marginal utility.

The estimates of standard deviations of the taste parameters are non-significant at conventional significance levels for all characteristics except for the *Kids* segment dummy

---

<sup>14</sup>If price entered in a log form these elasticities would all be roughly equal. Beyond the discussion of what is the "correct" functional form, this is disturbing because arbitrary assumptions on functional forms will determine a key result.

variable. Most interactions with demographics are significant. Marginal utility from sugar decreases with income. Marginal valuation of sogginess increases with income. In other words, wealthier (and possibly more health conscious) consumers are less sensitive to the crispness of a cereal. In general these results are similar to those presented in Nevo (1997b), see there for a detailed discussion of the results and the economic implications.

The results suggest that individual price sensitivity is heterogenous. The estimate of the standard deviation is not statistically significant, suggesting that most of the heterogeneity is explained by the demographics. Consumers with above average income tend to be less price sensitive as are adults.<sup>15</sup> Allowing the price coefficient to be a non-linear function of income is important (see Nevo 1997b). Further non-linearity was explored by adding additional powers of income, but in general were found to be non-significant.

Once again, due to lack of space I limit the discussion of the results to the implied own- and cross- price elasticities. For a detailed discussion of results similar to the ones presented here see Nevo (1997a). Table 5 presents a sample of own- and cross-price elasticities implied by the results of the full model. We note that the two problems of the Logit results are not present here. The own-price elasticities are not linear in price, despite the fact that price enters in a linear form. This is due to the heterogeneity in the price sensitivity: the consumers that purchase the different products have different price sensitivity. The problem with the cross-price elasticities is also not present as explained in Section 3.1.

#### *Additional Specifications and Sensitivity Analysis*

Whenever the estimation relies on structural assumption it is important to verify that the results are robust to changes in that structure. The estimation results presented in the previous

---

<sup>15</sup>Probably the right way to think about this is that households with kids will be more price sensitive than households without kids, everything else equal.

section are no different. Several sensitivity assumptions were performed but due to limitations in space are not presented here (for some of these see Nevo, 1997a). Sensitivity to definition of key variables (for example the share of the outside good), functional form (mainly in the interaction with demographics) and distributional assumptions, was performed. The results presented here were found to be robust.

The main alternative method to the one used in the previous section is the multi-level demand system presented in Section 3. A comparison of the results presented here has both a methodological interest and a practical interest, since these methods have been used to evaluate some recent mergers. Such a comparison is beyond the scope of this paper, but can be found in Nevo (1997a Chapter 6). Using the same data as in this paper I find there that the multi-level demand system yields, for this industry, somewhat disturbing cross-price elasticities. Some of the cross-price elasticities are estimated to be negative, which through adding up constraints allows other elasticities to be positive but very large. Furthermore, this "wrong" sign occurs most often for those products that we believe are close substitutes (for example between Post and Kellogg Raisin Bran). If used in the analysis below this would yield peculiar results (for example if Post and Kellogg merged then the price of both Post and Kellogg's Raisin Bran would decrease). This phenomenon is not limited just to our data and appears also in Hausman (1996). It however might be limited to specifics of the RTE cereal industry, since it does not seem to happen in the studies of Hausman, Leonard and Zona (1994) and Ellison et al. (1997). Study of these differences is the subject of ongoing work.

#### *4.2 Recovering Marginal Costs*

Marginal costs are recovered by assuming a pre-merger Nash-Bertrand equilibrium, as described in the Section 3.2. In order for the simulations below to make sense, demand was

calibrated to the observed levels. This insures that the simulated merger results are comparable to a no-merger situation. Or in other words, the simulated price increase without a merger will equal the observed price. In models without explicit heterogeneity in the individual probability of purchasing a brand (for example the Logit model) this calibration can be preformed by adding a “residual” to the predicted market shares. However, in models with explicit heterogeneity, like the model used here, this procedure can cause predicted individual probabilities of purchase to be negative. Therefore, the calibration was performed by adding the residual from the estimation directly to the indirect utility given in equation (4). The predicted marginal costs are displayed in Table 7.

The results for the Logit model are somewhat strange. The markup (price minus marginal cost) is equal for all brands of the same firm. This is a direct result of the restrictions of the Logit model and has nothing to do with reality. In other words, margins predicted by the Logit model decrease with price: the lower the price the higher the margin. The full model allows for heterogeneity in the marginal valuation of the brands and therefore frees the restrictions that cause this behavior. Indeed, both the marginal costs and the margin seem more reasonable.

#### *4.3 Computing Post-Merger Equilibrium*

For the post merger behavior four different situations were examined. First, I examine the model used in previous work in which instead of computing the new price equilibrium the approximation given in equation (11) was used. I use this assumption with the Logit estimates of demand and the estimates from the full model. The Logit model is similar to that used in much of previous work and therefore this can be used as a baseline comparison.<sup>16</sup> Using this model of

---

<sup>16</sup>Strictly speaking the “simple” Logit model used here was not used, rather the Antitrust Logit or the Nested Logit (see Werden and Froeb 1994). Although these models improve on many of the problems of the Logit model the results will be similar to those presented below.

computation with the full model of demand splits the difference between the procedure proposed here and the baseline comparison into two: that which is due to the estimates of demand and that which is due to fully computing the post-merger equilibrium. The next procedure examined uses the estimates from the full model of demand to compute the new Nash-Bertrand equilibrium. Finally, I examine the latter procedure and assume an arbitrary 5 percent reduction in marginal costs for merging firms.

All computations are based on the demand estimates presented in Table 5. The post-merger equilibrium was computed for each of the 45 cities in the sample using the data of the last quarter of 1992. Tables 8-11 present the median percent increase in prices over all cities.

In 1992, Kraft, which owns Post, acquired the Nabisco cereal line. This merger was challenged by the state of New-York, and was approved by the court. The main argument of the state was that the high level of substitution between Post Grape Nuts and Nabisco Shredded Wheat will cause an increase in the price of these products, if the merger is approved. The merger between these firms was simulated and the results are presented in Table 8. For this merger, either way of computing the post-merger equilibrium results in a small predicted price increase. If the merger generates cost efficiencies then it might actually lead to a reduction in price. Given the small production scale of Nabisco before the merger, a 5 percent cost reduction is not totally unreasonable.

In August of 1996 General Mills purchased from Ralston the Chex cereal line. This marked a change in the strategy of Ralston that decided to concentrate on its private label cereals.<sup>17</sup> This merger was not challenged. The increase in price is computed and presented in

---

<sup>17</sup>Ralston is the only one of the national manufacturers that produces private label cereals, and is the largest producer of such brands.

Table 9. Unlike before the procedure used to compute the equilibrium changes the result.

Computing the new equilibrium results in an increase in the price of Chex that is nearly twice the increase computed from the approximation. Furthermore, we see a result that will become even more striking below: the simulations based on the Logit model are not even close to the “true” answer.

These results raise the question: does a price increase of this magnitude justify regulatory intervention? It is not clear how to answer this question without a clear model of what the decision makers’ loss function is, an issue I will return to below.

For this merger there are potentially other considerations that can counter balance the price increase. Ralston will now concentrate on its private label business, and through that will supply what seems to be the main check of the price of branded cereal. In the results presented here this effect was not incorporated, but if the set of products for which we estimated demand included generic brands we could in principle capture this effect.

The last two mergers considered are between Quaker Oats (or its three brands in the sample) and either Kellogg or General Mills. Both of these are hypothetical mergers and are used only in order to demonstrate the method proposed here. The results from simulating these thought experiments can be seen in Tables 10 and 11.

Like the previous merger the predicted price increase differs between the full computation and the approximation. We note though that the difference here is smaller than before and it is not necessarily monotonic. Now the Logit results are very far from the truth, which is not surprising. Due to the symmetry assumption embodied in the Logit model simulation essentially counts how many products each firm has, it does not take account of any true measure of distance between products in some attribute space. All the results are telling us is that the portfolios of either

Kellogg or General Mills are much closer to the portfolio of Quaker Oats than what is suggested by the Logit model.

The results in Tables 8-11 demonstrate the effect of a merger on prices. However, they do not give any indication to whether these price changes are large or not. The right measure in which to answer this question is the influence of the merger on welfare. The results presented in Table 12 use equation (12), and a sample of individuals from the CPS to derive changes in consumer surplus, profits and total welfare.

## **5. DISCUSSION**

This paper presented an approach to simulating price equilibria, and its implications for social welfare, that result from a merger. The approach was used to examine four mergers in the ready-to-eat cereal industry: two real and two hypothetical. Two methodological conclusions can be drawn from the results. First, the model used for the front-end estimation of demand is important in determining the results of the simulation. Specifically, the Logit model and its close relatives that have been used in some previous work are problematic. Second, the approximation used in previous work differ in some cases substantially from the “true” predicted price equilibrium.

The simulations in the previous section assume that the merger is between the brands of the merging firms included in the sample. In order to fully simulate the effects of a merger all the brands of the merging firms should be included. This is potentially important since the true gains from the mergers might be in the synergies between these brands, both on the demand and supply side. Using the model of demand presented here this is not a problem.

There could potentially be other dimensions of non-price competition between the firms in

the industry, for example advertising and brand introduction. The analysis in this paper does not take into account any post-merger changes in the behavior in these dimensions. For example, merging firms might change the number of new brands, and the way they introduce them. This change might have two effects: a direct effect on consumer welfare, and an indirect effect on long-run prices. The direct effect might be to increase (decrease) consumer welfare by more (less) variety. However, the long-run effect might be to create a barrier to entry (Schmalensee, 1978), thus, supporting higher long-run prices. In order to determine if these effects exist, or which dominates, we need a dynamic model of brand introduction in the industry,

Potentially these non-price dimensions could be introduced into the analysis by simulating the effects a merger would have on the policy functions determining these strategies. However, an empirical model of dynamic decisions, such as advertising and brand introduction, is beyond current knowledge. The algorithm offered by Pakes and McGuire (1994) is promising, and is the basis for work in progress that addresses these issues.

## REFERENCES

- Anderson, S.P., A. de Palma, and J.-F. Thisse (1992), *Discrete Choice Theory of Product Differentiation*, The MIT Press.
- Baker and Bresnahan (1985), “The Gains From Merger or Collusion in Product-Differentiated Industries” *The Journal of Industrial Economics*, 33(4), 427-444.
- Barten, A.P. (1966), *Theorie en Empirie van een Volledig Stelsel van Vraagvergelijkingen*, Doctoral dissertation, Rotterdam: University of Rotterdam.
- Berry, S. (1994), “Estimating Discrete-Choice Models of Product Differentiation,” *Rand Journal of Economics*, 25, 242-262.
- Berry, S., J. Levinsohn, and A. Pakes (1995), “Automobile Prices in Market Equilibrium,” *Econometrica*, 63, 841-890.
- Berry, S., and A. Pakes (1993), “Some Applications and Limitations of Recent Advances in Empirical Industrial Organization: Merger Analysis,” *American Economic Review*, 83(2), 247-252.
- Bresnahan, T., S. Stern, and M. Trajtenberg (1996), “Market Segmentation and the Sources of Rents from Innovation: Personal Computers in the Late 1980's,” mimeo.
- Cardell, N.S. (1989), *Extensions of the Multinomial Logit: The Hedonic Demand Model, The Non-Independent Logit Model, and the Ranked Logit Model*, Ph.D. Dissertation, Harvard University.
- Chamberlain, G. (1982), “Multi Variate Regression Models for Panel Data,” *Journal of Econometrics*, 18(1), 5-46.
- Christensen, L.R., D.W. Jorgenson, and L.J. Lau (1975), “Transcendental Logarithmic Utility Functions,” *American Economic Review*, 65, 367-83.

- Deaton, A., and J. Muellbauer (1980a), "An Almost Ideal Demand System," *American Economic Review*, 70, 312-326.
- Deaton, A., and J. Muellbauer (1980b), *Economics and Consumer Behavior*, Cambridge University Press.
- Dixit, A., and J.E. Stiglitz (1977), "Monopolistic Competition and Optimum Product Diversity," *American Economic Review*, 67, 297-308.
- Ellison, S.F., I. Cockburn, Z. Griliches, and J. Hausman (1997), "Characteristics of Demand for Pharmaceutical Products: An Examination of Four Cephalosporins," *The Rand Journal of Economics*, 28(3).
- Encaoua, D., and A. Jacquemin (1980), "Degree of Monopoly, Indices of Concentration and Threat of Entry," *International Economic Review*, 21, 87-105.
- Gorman, W.M. (1959), "Separable Utility and Aggregation," *Econometrica*, 27, 469-81.
- Hausman, J. (1983), "Specification and Estimation of Simultaneous Equations Models," in Z. Griliches and M. Intriligator, eds., *Handbook of Econometrics*, Amsterdam: North Holland.
- Hausman, J. (1996), "Valuation of New Goods Under Perfect and Imperfect Competition," in T. Bresnahan and R. Gordon, eds., *The Economics of New Goods*, Studies in Income and Wealth Vol. 58, Chicago: National Bureau of Economic Research.
- Hausman, J., G. Leonard, and J.D. Zona (1994), "Competitive Analysis with Differentiated Products," *Annales D'Economie et de Statistique*, 34, 159-80.
- Hicks, J.R. (1936), *Value and Capital*, Oxford University Press.
- Leontief, W. (1936), "Composite Commodities and the Problem of Index Numbers," *Econometrica*, 4, 39-59.

- McFadden, D. (1973), "Conditional Logit Analysis of Qualitative Choice Behavior," in P. Zarembka, eds., *Frontiers of Econometrics*, New York, Academic Press.
- McFadden, D. (1978), "Modeling the Choice of Residential Location," in A. Karlqvist, et al., eds., *Spatial Interaction Theory and Planning Models*, Amsterdam: North-Holland.
- McFadden, D. (1984), "Econometric Analysis of Qualitative Response Models," in Z. Griliches and M. Intriligator, eds., *Handbook of Econometrics, Volume III*, Amsterdam: North-Holland.
- Nevo, A. (1997a), *Demand for Ready-to-Eat Cereal and Its Implications for Price Competition, Merger Analysis, and Valuation of New Goods*, Ph.D. Dissertation, Harvard University.
- Nevo, A. (1997b), "Measuring Market Power in the Ready-to-Eat Cereal Industry," University of California at Berkeley, mimeo (also available at <http://emlab.berkeley.edu/users/nevo/index.html> ).
- Nevo, A. (1997c), "A Research Assistant's Guide to Random Coefficients Discrete Choice Models of Demand," University of California at Berkeley, mimeo (also available at <http://emlab.berkeley.edu/users/nevo/index.html> ).
- Nevo, A. (1997d), "Identification of the Oligopoly Solution Concept in a Differentiated-Products Industry," University of California at Berkeley, mimeo
- Pakes, A., and P. McGuire (1994), "Computation of Markov Perfect Equilibria: Numerical Implications of a Dynamic Differentiated Product Model," *Rand Journal of Economics*, 25(4), 555-589.
- Schmalensee, R. (1978), "Entry Deterrence in the Ready-to-Eat Breakfast Cereal Industry," *Bell Journal of Economics*, 9, 305-327.
- Shapiro, C. (1996), "Mergers with Differentiated Products," *Antitrust*, 10(2), 23-30.

- Spence, M. (1976), "Product Selection, Fixed Costs, and Monopolistic Competition," *Review of Economic Studies*, 43, 217-235.
- Stone, J. (1954), "Linear Expenditure Systems and Demand Analysis: An Application to the Pattern of British Demand," *Economic Journal*, 64, 511-527.
- Theil, H. (1965), "The Information Approach o Demand Analysis," *Econometrica*, 6, 375-80.
- Trajtenberg, M. (1989), "The Welfare Analysis of Product Innovations, with an Application to Computed Tomography Scanners," *Journal of Political Economy*, 97(2), 444-479.
- Werden, G.J. (1992a), "The History of Antitrust Market Delineation," *The Marquette Law Review*, 76, 123-215.
- Werden, G.J. (1992b), "Four Suggestions on Market Delineation," *The Antitrust Bulletin*, 107-121.
- Werden, G.J. (1997), "Simulating the Effects of Differentiated Products Mergers: A Practitioners' Guide," Proceedings of the NE-165 Conference.
- Werden, G.J. and L. M. Froeb (1994), "The Effects of Mergers in Differentiated Products Industries: Logit Demand and Merger Policy," *Journal of Law, Economics, & Organization*, 194, 407-26.
- Willig, R.D. (1991), "Merger Analysis, Industrial Organization Theory, and the Merger Guidelines," *Brookings Papers on Economic Activity, Microeconomics*, 281-332.

## DATA AND ESTIMATION APPENDIX

### *Data*

Market shares and prices were obtained from the IRI Infoscan Data Base at the University of Connecticut.<sup>18</sup> These data were collected by Information Resources, Inc. (IRI), a marketing firm in Chicago, using scanning devices in a national random sample of supermarkets located in various size metropolitan areas and rural towns. Weekly data for UPC-coded products are drawn from a sample which represents the universe of supermarkets with annual sales of more than \$2 million dollars, accounting for 82% of grocery sales in the US. In the Infoscan Data Base the data are aggregated by brand (for example different size boxes are considered one brand), city<sup>19</sup> and quarter. The data covers up to 45 different cities (the exact number increases over time), and ranges from the first quarter of 1988 to the last quarter of 1992.

Market shares are defined by converting volume sales into number of servings sold,<sup>20</sup> and dividing by the total potential number of servings in a city in a quarter. This potential was assumed to be one serving per capita per day.<sup>21</sup> The outside good market share was defined as the residual between one and the sum of the observed market shares.

A price variable was created by dividing the dollar sales by the number of servings sold, and was deflated using a regional urban consumers CPI. The dollar sales reflect the price paid by consumers at the cashier, generating an average real per serving transaction price. However, the

---

<sup>18</sup>I am grateful to Ronald Cotterill, the director of the Food Marketing Center at the University of Connecticut, for making these data available.

<sup>19</sup>Most of IRI's definition of cities are similar, but not identical, to MSA's.

<sup>20</sup>This was done by using the serving weight suggested by the manufacturer, which are assumed correct (or at least proportional to the "true" serving weight).

<sup>21</sup>Therefore, the total market size is defined as  $\tau$ \*population\*365/4, with  $\tau$  is assumed equal to 1. Alternatively,  $\tau$  can be estimated.

sales data does not account for any coupons used post purchase. If coupons are used evenly across brands this is not a problem; otherwise the results are potentially biased. One should keep in mind that the data are from a period when coupons were issued less frequently than they are today.

The Infoscan data was matched with a few other sources. First, advertising data was taken from the Leading National Advertising data base, which contains quarterly national advertising expenditures by brand collected from 10 media sources.<sup>22</sup> I used only the total of the 10 types of media.

Product characteristics were collected in local supermarkets by examining cereal boxes. This implicitly assumes that the characteristics have not changed since 1988. Although this is not exactly true, it seems a reasonable first approximation. Each cereal was classified into "mushy" or not, depending on its sogginess in milk.<sup>23</sup> There might be some measurement error in this classification.

Information on the distribution of demographics was obtained by sampling individuals from the March Current Population Survey for each year. Individual income was obtained by dividing household income by the size of the household.

Finally, instrumental variables were constructed using two additional data sources. An average of wages paid in the supermarket sector in each city was constructed from the NBER CPS Monthly Earning Extracts. Estimates of city density were taken from the BLS, as were regional price indices.

### *Estimation*

I now describe how the discrete choice model described in the paper was estimated. Only

---

<sup>22</sup>The sources include: magazines, Sunday magazines, newspapers, outdoor, network television, spot television, syndicated television, cable networks, network radio and national spot radio.

<sup>23</sup>I wish to thank Sandy Black for suggesting this variable and helping me classify the various brands.

the basic ideas are given. The reader is referred to Nevo (1997c) for details. The essential idea is to aggregate the individual model of demand described by equations (4) and (5) to generate a predicted aggregate demand, which is a function of the parameters to be estimated. The parameters are chosen so to minimize the distance between the prediction and the observed demand. Since we observe aggregate demand for several markets (900 city-quarter combinations, to be precise) and the distribution of the individual characteristics that govern this demand vary between the markets, we are able to estimate the individual demand parameters. In constructing the measure of distance between observed and predicted shares I follow the suggestion of Berry (1994) to construct a GMM estimator, which controls for the endogeneity of prices.

Formally, combining (4) and (5) we get

$$\begin{aligned}
 u_{ijt} &= \delta_{jt}(x_j, p_{jt}, \xi_j, \Delta \xi_{jt}, \theta_1) + \mu_{ijt}(x_j, p_{jt}, v_i, D_i, \theta_2) + \varepsilon_{ijt} \\
 \delta_{jt} &= x_j \beta - \alpha p_{jt} + \xi_j + \Delta \xi_{jt}, \quad \mu_{ijt} = [p_{jt}, x_j] * (\Pi D_i + \Sigma v_i)
 \end{aligned}
 \tag{13}$$

where  $[p_{jt}, x_j]$  is a  $(K+1) \times 1$  vector,  $\theta = (\theta_1, \theta_2)$  is a vector containing all the parameters of the model. The vector  $\theta_1 = (\alpha, \beta)$  contains the linear parameters and the vector  $\theta_2 = (\Pi, \Sigma, \pi_0, \sigma_0)$  the non-linear parameters<sup>24</sup>. The utility is now expressed as the mean utility, represented by  $\delta_{jt}$ , and a mean zero heteroskedastic deviation from that mean,  $\mu_{ijt} + \varepsilon_{ijt}$ , that captures the effects of the random coefficients.

Consumers are assumed to purchase one unit of the good that gives the highest utility. This implicitly defines the set of unobserved variables that lead to the choice of good  $j$ . Let this set be

$$A_{jt}(x, p, \delta, \theta_2) = \left\{ (D_l, v_l, \varepsilon_{ilt}) \mid u_{ijt} \geq u_{ilt} \quad \forall l=0, 1, \dots, J \right\}$$

---

<sup>24</sup>The reasons for names will be apparent below.

where  $x$  are the characteristics of all brands,  $p_{.t} = (p_{1t}, \dots, p_{Jt})'$  and  $\delta_{.t} = (\delta_{1t}, \dots, \delta_{Jt})'$ . Assuming ties occur with zero probability, the market share of the  $j$ th product, as a function of the mean utility levels of all the  $J+1$  goods, given the parameters, is

$$\begin{aligned} s_{jt}(x, p, \delta_{.t}; \theta_2) &= \int_{A_{jt}} dP^*(D, v, \varepsilon) = \int_{A_{jt}} dP^*(\varepsilon|D, v) dP^*(v|D) dP^*(D) \\ &= \int_{A_{jt}} dP^*(\varepsilon) dP^*(v) dP^*(D) , \end{aligned} \quad (14)$$

where  $P^*(\cdot)$  denotes population distribution functions. The second equality is a direct application of Bayes rule, while the last is a consequence of the modeling assumptions made in (4) and (5).

By making distributional assumptions on the unobserved quantities we can solve the integral in (14). For the results presented in this paper I assume that  $\varepsilon$  is distributed extreme value,  $v$  is distributed as a multi-variate normal, and  $D$  is distributed according to the non-parametric empirical distribution (sampled from the CPS). The assumption of extreme value is innocent (given that  $v$  and  $D$  have non-degenerate distributions) and is made for computational convenience. The normality assumption is not innocent in theory but in practice will not alter our results (see Nevo 1997b). Finally, equation (4) makes functional form assumption. The results of exploration of flexible functional forms are presented in Nevo (1997a).

Let  $Z = [z_1, \dots, z_M]$  be a set of instruments such that

$$E[Z \cdot \omega(\theta^*)] = 0 , \quad (15)$$

where  $\omega$ , a function of the model parameters, is an "error term" defined below and  $\theta^*$  denotes the "true" value of these parameters. The GMM estimate is

$$\hat{\theta} = \underset{\theta}{\operatorname{argmin}} \omega(\theta)' Z A^{-1} Z' \omega(\theta) \quad (16)$$

where  $A$  is a consistent estimate of  $E[Z' \omega \omega' Z]$ . Following Berry (1994), the "error term" is not

defined as the difference between the observed and predicted market shares; rather it is defined as the structural error term in equation (4),  $\Delta\xi_{jt}$ . In order to obtain a moment function that is linear in this term we invert the market share function to obtain the vector of mean valuations that equates the observed market shares to the predicted shares. This is done by solving, for each market, the implicit system of equations

$$s_{jt}(\delta_{jt}; \theta_2) = S_{jt} .$$

In some cases (for example, the Logit model and one level Nested Logit) this can be solved analytically. However, for the full model suggested above, this has to be done numerically.

Once this inversion has been done, either analytically or numerically, the "error term" is defined as

$$\omega_{jt} = \delta_{jt}(S_{jt}; \theta_2) - (x_{jt}\beta + \alpha p_{jt}) . \tag{17}$$

Note, that it is the observed market shares,  $S$ , that enter this equation. Also, we can now see the reason for distinguishing between  $\theta_1$  and  $\theta_2$ :  $\theta_1$  enters this term, and the GMM objective, in a linear fashion, while  $\theta_2$  enters non-linearly.

Usually in these types of models<sup>25</sup>, the error term, as defined by (17), is the unobserved product characteristic,  $\xi_j$ . However, due to the richness of my data I am able to include a brand dummy as a regressor. This dummy includes both the mean quality index of observed characteristics,  $\beta x_j$ , and the unobserved characteristics,  $\xi_j$ . Thus, the error term is the city-quarter specific deviation from the main valuation, i.e.,  $\Delta\xi_{jt}$ . The inclusion of a brand dummy introduces a challenge in estimating the taste parameters,  $\beta$ , which is dealt with below.

In the Logit and Nested Logit models, with the appropriate choice of a weight matrix<sup>26</sup>,

---

<sup>25</sup>See for example Berry (1994), BLP (1995), Berry, Carnall, and Spiller (1994), Bresnahan, Stern and Trajtenberg (1996).

<sup>26</sup>I.e.,  $A=Z'Z$ , which is the "optimal" weight matrix under the assumption of homoscedastic errors.

this procedure simplifies to two-stage least squares. In the full random coefficients model, both the computation of the market shares, and the "inversion" in order to get  $\delta_{jt}(\cdot)$ , have to be done numerically. The value of the estimate is computed using a non-linear search. For the details of the computation see Nevo (1997c).

### *Instruments*

The key identifying assumption in the algorithm previously given is equation (15), which requires a set of exogenous instruments. The first set that comes to mind are the instruments defined by ordinary least squares, namely the dependent variables (or more generally the projections of the derivatives, of the non-linear objective function with respect to the parameters, on to the dependent variables). In order to determine the validity of this assumption we examine the pricing decision. Prices are a function of marginal costs and a markup term,

$$p_{jt} = mc_{jt} + f(\xi_{jt}, \dots) = (mc_j + f_j) + (\Delta mc_{jt} + \Delta f_{jt}) . \quad (18)$$

This can be decomposed into a national component (that does not vary by city and quarter), and a deviation from this national mean. As pointed out, once a brand dummy is included in the regression, the error term is the unobserved city-quarter specific deviation from the national time mean valuation of the brand. Since we assume that players in the industry observe and account for this deviation, it will influence the market specific markup term and bias the estimate of price sensitivity,  $\alpha$ , towards zero.

Different sets of instrumental variables have been proposed and tried in the literature. Elsewhere I compared these different IV (see Nevo 1997b). Based on that comparison, in this paper I exploit the panel structure of the data. The identifying assumption is that, controlling for brand specific means and demographics, city specific valuations are independent across cities (but

are allowed to be correlated within a city over time)<sup>27</sup>. Given this assumption, the prices of the brand in other cities are valid instruments; from (18) we see that prices of brand  $j$  in two cities will be correlated due to the common marginal cost, but due to the independence assumption will be uncorrelated with market specific valuation. Potentially, one could use the prices in all other cities and all quarters as instruments. I use regional quarterly average prices (excluding the city being instrumented) from all quarters.<sup>28</sup>

There are several plausible situations in which the independence assumption will not hold (see Nevo, 1997b). Therefore, I explore a set of direct proxies for marginal costs. Marginal costs include production (materials, labor and energy), packaging, and distribution costs. Direct production and packaging costs exhibit little variation, and are too small a percentage of marginal costs, to be correlated with prices. Also, except for small variations over time, a brand dummy variable, which is included as one of the regressors, proxies for these costs. The last component of marginal costs, distribution costs, includes: costs of transportation, shelf space, and labor. These are proxied by region dummy variables, which pick up transportation costs; city density, which is a proxy for the difference in the cost of space; and average city earning in the supermarket sector computed from the CPS Monthly Earning Files.

### *Fixed Brand Effects*

The empirical specification includes a brand dummy variable as one on the product characteristics. This variable captures the effects of all brand characteristics, observed and unobserved, that are constant across markets, improves the fit of the model and reduces the

---

<sup>27</sup>This assumption is similar to the one made in Hausman (1996), although our setups differ substantially.

<sup>28</sup>There is no claim made here with regards to the “optimality” of these instruments. A potentially interesting question might be are there other ways of weighting the information from different cities.

endogeneity problem (by controlling for some of the unobserved quality). In order to recover the mean taste for any observed characteristic that is fixed between markets a minimum distance procedure is used (as in Chamberlain, 1982).

Let  $d=(d_1, \dots, d_J)'$  denote the  $J \times 1$  vector of brand dummy coefficients,  $X$  be the  $J \times K$  ( $K < J$ ) matrix of product characteristics, and  $\xi=(\xi_1, \dots, \xi_J)'$  be the  $J \times 1$  vector of unobserved product qualities. Then from (4)

$$d = X\beta + \xi .$$

The estimates of  $\beta$  and  $\xi$  are

$$\hat{\beta} = (X' \Omega^{-1} X)^{-1} X' \Omega^{-1} \hat{d}, \quad \hat{\xi} = \hat{d} - X \hat{\beta}$$

where  $\hat{d}$ , is the vector of coefficients estimated from the procedure described in the previous section, and  $\Omega$  is the variance-covariance matrix of these estimates. The coefficients on the brand dummies provide an "unrestricted" estimate of the mean utility. The minimum distance estimates project these estimates onto a lower dimensional space, which is implied by a "restricted" model that sets  $\xi$  to zero. Chamberlain provides a  $\chi^2$  test to evaluate these restrictions.

TABLE 1A  
VOLUME MARKET SHARES

	88Q1	88Q4	89Q4	90Q4	91Q4	92Q4
Kellogg	41.39	39.91	38.49	37.86	37.48	33.70
General Mills	22.04	22.30	23.60	23.82	25.33	26.83
Post	11.80	10.30	9.45	10.96	11.37	11.31
Quaker Oats	9.93	9.00	8.29	7.66	7.00	7.40
Ralston	4.86	6.37	7.65	6.60	5.45	5.18
Nabisco	5.32	6.01	4.46	3.75	2.95	3.11
C3	75.23	72.51	71.54	72.64	74.18	71.84
C6	95.34	93.89	91.94	90.65	89.58	87.53
Private Label	3.33	3.75	4.63	6.29	7.13	7.60

Source: IRI Infoscan Data Base, University of Connecticut, Food Marketing Center.

TABLE 1B  
SALES MARKET SHARES

	88Q1	88Q4	89Q4	90Q4	91Q4	92Q4
Kellogg	41.23	39.84	38.16	37.26	36.00	32.57
General Mills	24.73	25.16	26.86	27.70	29.66	31.39
Post	11.15	9.87	8.76	10.56	11.19	10.97
Quaker Oats	9.46	8.54	8.26	7.30	6.89	6.94
Ralston	5.12	6.61	7.80	7.03	5.78	5.45
Nabisco	5.00	5.59	4.13	3.58	3.04	3.33
C3	77.11	74.87	73.78	75.52	76.85	74.93
C6	96.69	95.61	93.97	93.43	92.56	90.65
Private Label	2.12	2.30	2.81	3.74	4.28	4.55

Source: IRI Infoscan Data Base, University of Connecticut, Food Marketing Center.

TABLE 2  
BRANDS USED FOR ESTIMATING DEMAND

All Family/ Basic Segment	Taste Enhanced Wholesome Segment	Simple Health Nutrition Segment	Kids Segment
K Corn Flakes	K Raisin Bran	P Grape Nuts	K Frosted Flakes
GM Cheerios	K Frosted Mini Wheats	N Shredded Wheat	GM H-N Cheerios
K Rice Krispies	P Raisin Bran	GM Total	Q CapN Crunch
GM Wheaties	K Cracklin Oat Bran	K NutriGrain	K Froot Loops
Ralston Chex	Q 100% Natural	K Special K	GM Lucky Charms
K Crispix	GM Raisin Nut		GM Trix
			Q Life

TABLE 3  
RESULTS FROM LOGIT DEMAND  
(21,600 OBSERVATIONS)

Variable	OLS			IV		
	(i)	(ii)	(iii)	(iv)	(v)	(vi)
Price	-8.57 (0.179)	-12.60 (0.436)	-12.65 (0.467)	-16.61 (0.443)	-16.97 (0.483)	-18.21 (0.439)
Advertising	0.034 (0.002)	0.032 (0.002)	0.032 (0.002)	0.030 (0.002)	0.030 (0.002)	0.030 (0.002)
log median income	--	--	--	0.99 (0.021)	1.00 (0.022)	1.01 (0.022)
log of median age	--	--	--	-0.02 (0.06)	0.01 (0.06)	0.04 (0.06)
median HH size	--	--	--	-0.03 (0.03)	-0.02 (0.03)	-0.02 (0.03)
<b>Measures of fit:<sup>a</sup></b>	0.76	99.1 (30.1)	98.7 (16.9)	59.0 (30.1)	51.3 (16.9)	54.8 (42.6)
<b>First Stage:</b>						
R <sup>2</sup>	--	94.5	94.4	94.5	94.5	94.7
F-statistic	--	5179	6740	5046	6483	4959
<b>Instruments:</b>						
Avg regional prices	--	✓	--	✓	--	✓
Cost proxies	--	--	✓	--	✓	✓
<b>Own Price Elasticity:</b>						
Mean	-1.71	-2.51	-2.51	-3.31	-3.38	-3.62
Std.	0.51	0.75	0.75	0.99	1.01	1.09
Median	-1.60	-2.36	-2.36	-3.11	-3.18	-3.41
% of Inelastic Demands (+/- 2 s.e.'s)	4.4% (4.1-4.9%)	0	0	0	0	0

Dependant variable is  $\ln(S_{jt}) - \ln(S_{0t})$ . All regressions include time and brand dummy variables, robust standard errors are given in parenthesis.

<sup>a</sup>Adjusted R<sup>2</sup> for the OLS regression, and a test of over identification for the IV regressions (Hausman, 1983) with the 0.95 critical values in parenthesis.

TABLE 4  
OWN AND CROSS PRICE ELASTICITIES IMPLIED BY LOGIT DEMAND

	own-price elasticity	cross-price elasticity <sup>a</sup>
K Corn Flakes	-1.61	0.034
K Raisin Bran	-2.89	0.033
K Frosted Flakes	-2.48	0.047
K Rice Krispies	-2.23	0.034
K Frosted Mini Wheats	-4.59	0.024
K Froot Loops	-2.92	0.024
K Special K	-3.35	0.016
K NutriGrain	-2.99	0.011
K Crispix	-3.24	0.012
K Cracklin Oat Bran	-6.01	0.015
GM Cheerios	-2.99	0.051
GM Honey Nut Cheerios	-2.79	0.036
GM Wheaties	-2.44	0.014
GM Total	-3.50	0.033
GM Lucky Charms	-3.16	0.021
GM Trix	-3.72	0.016
GM Raisin Nut	-5.15	0.012
P Raisin Bran	-2.94	0.016
P Grape Nuts	-3.84	0.021
Q 100% Natural	-4.22	0.008
Q Life	-2.61	0.012
Q Cap N Crunch	-2.34	0.029
Chex	-3.22	0.010
N Shredded Wheat	-3.83	0.013

<sup>a</sup>Gives the percent change in market share of brand  $j$  with a one percent change in price of  $i$ , where  $i$  indexes row and  $j \neq i$ . The Logit functional form implies that these elasticities are equal for all  $j \neq i$ .

TABLE 5  
RESULTS FROM THE FULL MODEL  
(21,600 OBSERVATIONS)

Variable	Means ( $\beta$ 's)	Standard Deviations ( $\sigma$ 's)	Interactions with Demographic Variables:			
			Income	Income Sq	Age	Child
Price	-23.202 (8.172)	0.593 (2.896)	318.774 (150.411)	-18.243 (8.033)	-	-10.664 (2.238)
Advertising	0.025 (0.008)	-	-	-	-	-
Constant	-2.334 <sup>a</sup> (0.157)	0.007 (0.752)	3.367 (2.057)	-	-0.153 (0.737)	-
Cal from Fat	0.0135 <sup>a</sup> (0.005)	0.041 (0.034)	-	-	-	-
Sugar	0.199 <sup>a</sup> (0.011)	0.023 (0.054)	-0.361 (0.142)	-	0.071 (0.054)	-
Mushy	-1.220 <sup>a</sup> (0.311)	0.357 (0.926)	7.763 (2.656)	-	-0.396 (0.649)	-
Fiber	-0.059 <sup>a</sup> (0.009)	0.044 (0.056)	-	-	-	0.189 (0.078)
All-family	0.080 <sup>a</sup> (0.196)	0.260 (1.715)	-	-	-	-
Kids	-2.161 <sup>a</sup> (0.347)	2.755 (0.632)	-	-	-	-
Adults	1.646 <sup>a</sup> (0.503)	1.598 (1.078)	--	--	-	-
GMM Objective (degrees of freedom)			1.74 (8)			
MD $\chi^2$			586			
MD un-weighted $R^2$			0.11			
MD weighted $R^2$			0.71			
% of Price Coefficients >0			0			

Except where noted, parameters are GMM estimates. All regressions include brand and time dummy variables. Robust standard errors are given in parenthesis.

<sup>a</sup>Estimates from a minimum distance procedure.

TABLE 6  
MEDIAN OWN AND CROSS-PRICE ELASTICITIES

#	Brand	K Corn Flakes	K Raisin Bran	K Frosted Flakes	GM Cheerios	GM Lucky Charms	P Raisin Bran	P Grape Nuts	Q Life	Chex	Shredded Wheat
1	K Corn Flakes	-3.002	0.048	0.434	0.055	0.000	0.013	0.001	0.004	0.003	0.002
2	K Raisin Bran	0.049	-2.899	0.074	0.202	0.008	0.158	0.049	0.018	0.010	0.047
3	K Frosted Flakes	0.318	0.049	-3.116	0.067	0.013	0.016	0.003	0.049	0.006	0.004
4	K Rice Krispies	0.023	0.059	0.046	0.106	0.012	0.027	0.025	0.013	0.019	0.019
5	K Frosted Mini Wheats	0.000	0.052	0.002	0.055	0.016	0.033	0.048	0.008	0.008	0.022
6	K Froot Loops	0.001	0.010	0.027	0.021	0.077	0.005	0.012	0.032	0.006	0.005
7	K Special K	0.210	0.072	0.208	0.106	0.003	0.024	0.021	0.011	0.011	0.024
8	K NutriGrain	0.440	0.122	0.264	0.120	0.001	0.043	0.017	0.008	0.005	0.025
9	K Crispix	0.005	0.035	0.018	0.077	0.014	0.017	0.023	0.010	0.018	0.015
10	K Cracklin Oat Bran	0.001	0.053	0.004	0.120	0.012	0.026	0.031	0.011	0.010	0.013
11	GM Cheerios	0.037	0.126	0.064	-2.420	0.010	0.060	0.036	0.019	0.017	0.031
12	GM Honey Nut Cheerios	0.002	0.018	0.060	0.036	0.076	0.009	0.015	0.049	0.007	0.008
13	GM Wheaties	0.816	0.120	0.387	0.122	0.001	0.037	0.004	0.008	0.005	0.007
14	GM Total	0.209	0.060	0.211	0.104	0.003	0.018	0.017	0.011	0.011	0.019
15	GM Lucky Charms	0.001	0.012	0.031	0.025	-1.348	0.006	0.013	0.035	0.006	0.006
16	GM Trix	0.001	0.009	0.030	0.026	0.071	0.004	0.010	0.034	0.007	0.004
17	GM Raisin Nut	0.037	0.146	0.064	0.214	0.009	0.061	0.023	0.020	0.015	0.019
18	P Raisin Bran	0.027	0.324	0.050	0.194	0.008	-2.878	0.057	0.017	0.009	0.052
19	P Grape Nuts	0.002	0.076	0.008	0.086	0.013	0.043	-2.307	0.010	0.010	0.070
20	Q 100% Natural	0.006	0.068	0.015	0.155	0.012	0.031	0.025	0.014	0.013	0.014
21	Q Life	0.011	0.048	0.198	0.080	0.058	0.021	0.018	-1.931	0.009	0.013
22	Q CapNCrunch	0.003	0.020	0.083	0.041	0.074	0.009	0.013	0.054	0.008	0.007
23	Chex	0.010	0.032	0.029	0.084	0.012	0.014	0.019	0.011	-1.684	0.013
24	N Shredded Wheat	0.005	0.122	0.018	0.130	0.009	0.067	0.119	0.012	0.010	-3.036
25	Outside good	0.101	0.050	0.079	0.072	0.010	0.023	0.020	0.010	0.010	0.015

Cell entries  $i, j$ , where  $i$  indexes row and  $j$  column, give the percent change in market share of brand  $i$  with a one percent change in price of  $j$ .

TABLE 7  
PREDICTED MARGINAL COSTS

	median pre-merger price (¢ per serving)	median marginal cost (¢ per serving)		median margin (p-mc)/p	
		Logit	Full Model	Logit	Full Model
K Corn Flakes	9.8	3.1	5.5	68.5%	43.4%
K Raisin Bran	17.2	10.7	9.8	38.1%	43.2%
K Frosted Flakes	14.8	8.3	8.6	44.2%	41.6%
K Rice Krispies	13.1	6.5	2.6	50.4%	79.9%
K Frosted Mini Wheats	28.0	21.4	14.8	23.7%	47.0%
K Froot Loops	18.3	11.7	2.9	36.4%	84.1%
K Special K	20.6	14.1	15.2	31.7%	26.4%
K NutriGrain	18.0	11.4	12.5	36.4%	30.6%
K Crispix	19.3	12.6	5.2	34.3%	73.1%
K Cracklin Oat Bran	37.0	30.3	22.5	18.0%	39.2%
GM Cheerios	18.8	12.5	10.1	34.0%	46.4%
GM Honey Nut Cheerios	17.4	11.0	3.1	36.7%	81.9%
GM Wheaties	15.6	9.3	12.5	40.9%	20.2%
GM Total	22.2	15.8	17.1	28.7%	22.9%
GM Lucky Charms	20.2	13.8	2.8	31.8%	86.2%
GM Trix	23.0	16.7	5.1	27.8%	77.7%
GM Raisin Nut	32.8	26.4	24.7	19.6%	24.7%
P Raisin Bran	17.8	11.7	11.2	34.3%	36.8%
P Grape Nuts	23.6	17.5	14.0	25.8%	40.8%
Q 100% Natural	26.1	19.9	14.9	23.6%	42.8%
Q Life	15.6	9.5	6.4	39.2%	58.8%
Q Cap N Crunch	14.9	8.7	3.4	41.2%	77.4%
Chex	19.7	13.6	8.0	30.7%	59.4%
N Shredded Wheat	27.5	21.5	18.8	21.9%	31.8%

TABLE 8  
PERCENT INCREASE IN PRICES AS A RESULT OF THE POST-NABISCO MERGER

	pre-merger price (¢ per serving)	Logit		Full Model	
		approx	approx	new equilibrium	cost reduction
K Corn Flakes	9.8	--	--	0.0	-0.0
K Raisin Bran	17.3	--	--	0.0	-0.1
K Frosted Flakes	14.8	--	--	0.0	-0.0
K Rice Krispies	13.1	--	--	0.0	0.0
K Frosted Mini Wheats	28.0	--	--	0.0	0.0
K Fruit Loops	18.3	--	--	0.0	0.0
K Special K	20.7	--	--	0.0	-0.0
K NutriGrain	18.0	--	--	0.0	-0.0
K Crispix	19.3	--	--	0.0	0.0
K Cracklin Oat Bran	37.0	--	--	0.0	-0.0
GM Cheerios	18.8	--	--	0.0	0.0
GM HN Cheerios	17.4	--	--	0.0	0.0
GM Wheaties	15.6	--	--	0.0	-0.0
GM Total	22.2	--	--	0.0	-0.0
GM Lucky Charms	20.2	--	--	0.0	0.0
GM Trix	23.0	--	--	0.0	0.0
GM Raisin Nut	32.8	--	--	0.0	-0.0
P Raisin Bran	17.8	0.1	0.6	0.6	-3.0
P Grape Nuts	23.6	0.1	1.2	1.4	-1.8
Q 100% Natural	26.1	--	--	0.0	0.0
Q Life	15.6	--	--	0.0	0.0
Q Cap N Crunch	14.9	--	--	0.0	0.0
R Chex	19.7	--	--	0.0	0.0
N Shredded Wheat	27.5	0.2	2.2	2.8	-1.3

The columns labeled *approx* refer to the prices that result from computing the prices using the approximation given in equation (11) Since nothing changes for the non-merging firms the price increase will always be zero, and therefore is not displayed. The column labeled “new equilibrium” computes the new Nash-Bertrand equilibrium and the column labeled “cost reduction” does the same but assumes a 5% reduction in marginal costs for all brands of merging firms.

TABLE 9  
PERCENT INCREASE IN PRICES AS A RESULT OF THE GM-CHEX MERGER

	pre-merger price (¢ per serving)	Logit		Full Model	
		approx	approx	new equilibrium	cost reduction
K Corn Flakes	9.8	--	--	0.0	-0.6
K Raisin Bran	17.3	--	--	0.1	-0.1
K Frosted Flakes	14.8	--	--	0.0	-0.4
K Rice Krispies	13.1	--	--	0.1	0.5
K Frosted Mini Wheats	28.0	--	--	0.0	0.1
K Fruit Loops	18.3	--	--	0.0	0.1
K Special K	20.7	--	--	0.0	-0.2
K NutriGrain	18.0	--	--	0.0	-0.4
K Crispix	19.3	--	--	0.0	0.3
K Cracklin Oat Bran	37.0	--	--	0.0	0.1
GM Cheerios	18.8	0.1	0.6	0.7	-2.4
GM HN Cheerios	17.4	0.1	0.5	0.5	-0.3
GM Wheaties	15.6	0.2	0.1	0.0	-3.5
GM Total	22.2	0.1	0.3	0.2	-3.8
GM Lucky Charms	20.2	0.1	0.5	0.5	-0.4
GM Trix	23.0	0.1	0.5	0.6	-0.5
GM Raisin Nut	32.8	0.1	0.3	0.3	-3.9
P Raisin Bran	17.8	--	--	0.0	0.1
P Grape Nuts	23.6	--	--	0.0	0.1
Q 100% Natural	26.1	--	--	0.0	0.1
Q Life	15.6	--	--	0.1	0.1
Q Cap N Crunch	14.9	--	--	0.0	0.1
R Chex	19.7	1.8	6.3	11.6	8.9
N Shredded Wheat	27.5	--	--	0.0	0.1

The columns labeled *approx* refer to the prices that result from computing the prices using the approximation given in equation (11) Since nothing changes for the non-merging firms the price increase will always be zero, and therefore is not displayed. The column labeled “new equilibrium” computes the new Nash-Bertrand equilibrium and the column labeled “cost reduction” does the same but assumes a 5% reduction in marginal costs for all brands of merging firms.

TABLE 10  
PERCENT INCREASE IN PRICES AS A RESULT OF THE KELLOGG-QUAKER OATS MERGER

	pre-merger price (¢ per serving)	Logit		Full Model	
		approx	approx	new equilibrium	cost reduction
K Corn Flakes	9.8	1.3	1.1	0.0	-0.7
K Raisin Bran	17.3	0.8	2.2	0.9	-1.3
K Frosted Flakes	14.8	0.8	3.1	1.5	-0.2
K Rice Krispies	13.1	1.0	3.2	4.0	4.0
K Frosted Mini Wheats	28.0	0.5	1.8	1.7	-1.9
K Fruit Loops	18.3	0.7	11.3	13.6	12.1
K Special K	20.7	0.6	0.9	0.3	-2.8
K NutriGrain	18.0	0.7	0.8	0.1	-2.4
K Crispix	19.3	0.7	2.8	3.3	2.4
K Cracklin Oat Bran	37.0	0.4	3.2	3.6	-0.3
GM Cheerios	18.8	--	--	0.3	0.3
GM HN Cheerios	17.4	--	--	1.0	0.9
GM Wheaties	15.6	--	--	0.1	0.0
GM Total	22.2	--	--	0.1	0.1
GM Lucky Charms	20.2	--	--	0.9	0.8
GM Trix	23.0	--	--	0.7	0.6
GM Raisin Nut	32.8	--	--	0.2	0.2
P Raisin Bran	17.8	--	--	0.1	0.1
P Grape Nuts	23.6	--	--	0.0	0.0
Q 100% Natural	26.1	2.3	8.8	10.6	7.9
Q Life	15.6	3.9	16.5	15.7	14.9
Q Cap N Crunch	14.9	4.0	16.4	18.9	19.1
R Chex	19.7	--	--	-0.2	-0.1
N Shredded Wheat	27.5	--	--	0.0	0.0

The columns labeled *approx* refer to the prices that result from computing the prices using the approximation given in equation (11) Since nothing changes for the non-merging firms the price increase will always be zero, and therefore is not displayed. The column labeled “new equilibrium” computes the new Nash-Bertrand equilibrium and the column labeled “cost reduction” does the same but assumes a 5% reduction in marginal costs for all brands of merging firms.

TABLE 11  
PERCENT INCREASE IN PRICES AS A RESULT OF THE GM-QUAKER OATS MERGER

	pre-merger price (¢ per serving)	Logit		Full Model	
		approx	approx	new equilibrium	cost reduction
K Corn Flakes	9.8	--	--	0.1	-0.5
K Raisin Bran	17.3	--	--	0.4	0.3
K Frosted Flakes	14.8	--	--	0.7	0.2
K Rice Krispies	13.1	--	--	0.4	0.8
K Frosted Mini Wheats	28.0	--	--	0.1	0.1
K Fruit Loops	18.3	--	--	0.6	0.5
K Special K	20.7	--	--	0.2	-0.1
K NutriGrain	18.0	--	--	0.1	-0.3
K Crispix	19.3	--	--	0.0	0.2
K Cracklin Oat Bran	37.0	--	--	0.2	0.2
GM Cheerios	18.8	0.6	3.3	2.7	-0.4
GM HN Cheerios	17.4	0.7	15.3	15.0	15.2
GM Wheaties	15.6	0.7	0.5	0.1	-3.4
GM Total	22.2	0.5	0.9	0.3	-3.4
GM Lucky Charms	20.2	0.6	12.5	12.7	12.2
GM Trix	23.0	0.5	11.9	13.2	11.2
GM Raisin Nut	32.8	0.4	2.4	2.0	-2.4
P Raisin Bran	17.8	--	--	0.1	0.2
P Grape Nuts	23.6	--	--	0.0	0.0
Q 100% Natural	26.1	1.5	9.1	11.7	8.2
Q Life	15.6	2.4	24.7	22.7	20.9
Q Cap N Crunch	14.9	2.4	27.2	35.1	34.6
R Chex	19.7	--	--	-0.2	0.1
N Shredded Wheat	27.5	--	--	0.0	0.1

The columns labeled *approx* refer to the prices that result from computing the prices using the approximation given in equation (11) Since nothing changes for the non-merging firms the price increase will always be zero, and therefore is not displayed. The column labeled “new equilibrium” computes the new Nash-Bertrand equilibrium and the column labeled “cost reduction” does the same but assumes a 5% reduction in marginal costs for all brands of merging firms.

TABLE 12  
CHANGE IN PROFITS AND CONSUMER SURPLUS AS A RESULT OF A MERGER

	Post & Nabisco	General Mills & Chex	General Mills & Quaker Oats	Kellogg & Quaker Oats
<b>Consumer Surplus</b>	-10.86	-35.82	-222.25	-416.70
<b>Profits (total)</b>	5.04	8.40	90.30	158.48
Kellogg	2.46	4.51	26.62	72.93
General Mills	1.63	1.45	56.61	74.99
Post	0.47	0.59	4.51	6.32
Quaker Oats	0.40	1.64	–	–
Ralston	0.09	–	1.39	2.32
Nabisco	–	0.18	1.18	1.92
<b>Total Welfare</b>	-5.82	-27.42	-131.95	-258.22
with 5% reduction in mc:				
<b>Consumer Surplus</b>	8.64	20.54	-176.68	-357.52
<b>Profits (total)</b>	20.55	57.69	150.46	209.55
Kellogg	2.46	4.51	86.77	72.93
General Mills	1.63	50.78	56.61	126.07
Post	15.98	0.59	4.51	6.32
Quaker Oats	0.40	1.64	–	–
Ralston	0.09	–	1.39	2.32
Nabisco	–	0.18	1.18	1.92
<b>Total Welfare</b>	29.24	78.23	-26.22	-147.97

All computations are based on results of Tables 8-11.