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# Food Marketing Policy

## Issue Paper

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### Jawboning Cereal: The Campaign to Lower Cereal Prices

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# **Jawboning Cereal: The Campaign to Lower Cereal Prices**

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## **Abstract**

This article introduces the Forum by explaining the sequence of events related to the jawboning campaign and subsequent reductions in cereal prices. It also introduces the main issues on the vigor of competition and pricing that are analyzed in subsequent papers. Jawboning as a public policy strategy is assessed and found useful in certain circumstances such as those in the breakfast cereal industry in the mid 1990's. The jawboning campaign was effective in advancing price competition in an industry that successfully resisted repeated antitrust efforts to promote competition. The RTE cereal industry is now undergoing major structural changes that are on balance pro competitive. (ECONLIT Cites: L100, L410, L660)

**Key words:** jawboning, nonprice competition, market power, market concentration, antitrust enforcement

## **Jawboning Cereal: The Campaign to Lower Cereal Prices**

by Ronald W. Cotterill\*

This Agribusiness Forum contains a series of papers that were instrumental in the successful campaign in 1995-96 by Congressman Samuel Gjedenson of Connecticut and Senator Charles Schumer of New York to lower ready to eat breakfast cereal prices. In total, they are a case study of how jawboning can address market power issues in highly concentrated industries that effectively may be beyond the reach of the antitrust laws. Although special conditions are necessary for its success, jawboning can, on occasion, be a useful complement to other public policy actions.

Jawboning is not chewing cereal, rather it is the use of the bully pulpit by government officials to induce changes in industry conduct. As such it is a public policy strategy. Allan Greenspan's "irrational exuberance" speech on speculative excess the stock market is a recent example, and others abound in monetary economics where jawboning is a finely honed art. A classic industrial organization example, quite similar to the cereal case presented here, is John F. Kennedy's public excoriation of big steel for price increases and his successful call for price rollbacks in the early 1960's.

Jawboning only works when there is a large amount of uncertainty in the market as to the most profitable market strategy. This uncertainty may hinge on public opinion and policy options. The RTE cereal industry's record of excess profits and excess investment in production capacity, funded by a run away price promotion spiral, put it in a highly vulnerable position. As a Solomon Smith Barney analyst recently wrote:

"The U.S. ready-to-eat (RTE) cereal industry was brutally overcapitalized for at least the 15 years between 1979-1994, during which time we estimate category

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\* The author acknowledges the helpful comments of James MacDonald, however responsibility for content remains with the author.

leaders Kellogg and General Mills alone invested as much \$3.2-\$3.5 billion, adding incremental capacity of at least 55%-60%. During the same time, the manufacturers priced with virtual abandon, effecting increases averaging 7% per year, more than three times the average rate of food inflation.

“However, cereal consumption growth slowed sharply in 1994 to 1%, down from the decade-long 4% trend line, we believe reflecting the consumers’ perception of manufacturer price gouging as well the continued proliferation of more convenient breakfast alternatives. Further, we believe that the deceleration combined with the aggressive capacity expansion of the prior 15 years caused cereal industry manufacturing utilization rates to fall to very inefficient levels, perhaps as low as 60%, prompting list price cuts and significantly more aggressive price promotion activities.” (Mehring, p. 3)

Fine, but how one might ask can one link the congressional jawboning effect to price cuts in the cereal industry? Wouldn’t these changes have occurred anyway? Prior to 1995, the industry had been carefully managing and fine tuning their price and promotion strategies. They were very aware of a large reservoir of consumer resentment, but they were looking for a soft landing, not a crash. When the jawboning campaign hit in March 1995, it unleashed consumer shifts and plunged the industry into a free fall loss of sales for branded cereals, that it has yet to recover from. Branded sales dropped 2 percent in 1995, the first annual decline in branded cereal consumption on record (Gejdenson and Schumer, 1996). RTE cereal volume, in real terms, continue to fall, dropping 15 percent between 1994 and 1997 (*Business Week*, 10/12/98). During this time private label cereal volumes increased so the decline in branded cereal has been even larger. The linkage between jawboning and the break in prices is confirmed statistically in the last paper of this Forum. It also is confirmed by the bitter and raw exchanges that took place in the news media between the protagonists. Throughout the jawboning campaign the cereal industry categorically denied its prices were high blaming faulty measurement methods for the reported price increases (GMA, 1995). Post cereals

ran an advertisement featuring its General Manager, Mack Leckie, and his family conveying the message that real, family oriented, friendly people as opposed to a large impersonal corporation produced cereal at Post. Mr. Leckie sat through the entire (3 week) antitrust trial against Post that will be discussed at length in this Forum and thus was well schooled in the arguments against the industry that were presented there and here. When Mr. Leckie announced the Post Cereal 20 percent price cuts on *CNBC Business Roundtable* in April 1996, he openly conceded that cereals were overpriced. Congressman Gjedenson appeared immediately after Mr. Leckie on the same program, congratulated Mr. Leckie on cutting price, claimed victory in the jawboning campaign, and called for other cereal companies to follow Post. But these facts put us ahead of our story. Lets review the jawboning campaign more carefully.

As an introduction to the forum this paper explains the series of events and analyses that led to the cereal industry's announced 1996 price cuts. The second paper in the forum is "Consumers in a Box: A Consumer Report on Cereal." It is the March 5, 1995 whitepaper that Congressman Gjedenson and Senator Schumer, who at that time was a congressman, issued when they first called for lower cereal prices. Next is the industry's only public written response during the entire jawboning campaign. The industry used the Grocery Manufacturers of America, a trade and lobbying association, as their common spokesperson, and the GMA issued "Fact Sheet: Facts versus Myths about Breakfast Cereal Pricing and Promotion." Their public relations strategy understandably was to minimize coverage of the high cereal price issue by the news media.

The three papers after the GMA Fact Sheet are "High Cereal Prices and the Prospects for Relief by Expansion of Private Label and Antitrust Enforcement" by this author, "A Statement

on the Breakfast Cereal Industry” by Alfred Kahn, and “Breakfast Cereals: The Extreme Food Industry” by John Connor. These papers were presented at the March 12, 1996 congressional cereal pricing forum, organized on the anniversary of the jawboning effort to evaluate its impact and to press the issue. The follow up report “Consumers Still in a Box” by Congressman Gjedenson and Senator Schumer was also presented at the 1996 forum. The last paper in this issue uses Information Resources Inc. scanner data for the supermarket sales of cereal to track cereal prices and evaluate the impact of lower prices on consumers.

Ready-to-eat breakfast cereal is a key component in American diets. Fifty seven percent of children under the age of 12 eat it for breakfast. Children under the age of 18 consume 14 pounds of cereal per year and those over the age of 40 consume 9 pounds, accounting for the bulk of RTE cereal consumption (Berlinski, 1995a). Families with children and older Americans face serious income constraints more often than other demographic groups. Consequently the price of breakfast cereal is a significant concern for social welfare and has attracted public interest in many ways over the past 25 years.

The impact of cereal advertising on prices is questioned (Sutton, 1991). RTE cereal advertising, totaled 957 dollars in 1994, more than 12 percent of sales, making cereal one of the most intensely advertised products in the economy (LNA, 1995). The impact of TV advertising on kids is questioned. The *New York Times* goes to the nub of the issue writing

“Whether children eat the cheaper cereals depends in part who is more persuasive: a three foot tall child watching television commercials on Saturday morning or a six foot parent with purse strings.” (Berlinski, 1995b)

The merits of industry advertising on health claims, such as the benefits of high fiber cereals for reducing cholesterol, have been questioned, but have passed muster as beneficial (Ippolito and Mathios, 1990).

Product proliferation in the RTE cereal industry has also been questioned for its contribution to higher prices (Connor, 1981; Putsis, 1997). There is a trade off between product variety and price levels of individual products in this industry. Schmalensee (1978) and Scherer and Ross (1990) demonstrated that cereal product proliferation tends to produce barriers to entry and oligopolistic prices well in excess of marginal cost of production.

Profits in the industry averaged 17 percent of sales in the 1980s and first half of the 1990s, near the top for food manufacturing. The industry's return on equity and stock market valuation performance were also near the top for U.S. manufacturing corporations (Maubousin, 1994). Kellogg's stock price for example, increased more than ten fold between 1981 and 1994, but has significantly lagged the S&P 500 index since the advent of the jawboning campaign in early 1995 and was down more than 30 percent in 1998 (Kellogg's, 1993; Value Line Investment Survey, *Business Week* 10/12/98). In contrast, the stock price of Ralcorp, the leading manufacturer of private label, has increased 80 percent over the past two years (Balu, p. 1).

Given the industry's importance in American diets, its persistent focus on nonprice competition, and its price and profit performance, it is not surprising that the cereal industry has attracted considerable antitrust and regulatory oversight over the past 25 years. The FTC's shared monopoly case ran for nearly 10 years before being dismissed in 1981 without a trial on the merits (FTC vs. Kellogg Co.). Now regarded as the high water mark for application of Section 2 of the Sherman antitrust law to monopoly power in the U.S. economy, the FTC failed in its attempt to extend the law beyond the analysis of dominance by a single firm to the analysis of dominance by a group of leading firms (hence the term shared monopoly).

The next significant attempt to use the antitrust laws to inject price competition into this industry was the review and challenge of Phillip Morris/Kraft's acquisition of Nabisco Shredded

Wheat in 1992. The top six firms, Kelloggs, General Mills, Post (P. Morris/Kraft), Quaker, Ralston, and Nabisco, had dominated the RTE cereal industry since its inception at the beginning of the century, however major changes put the industry in play in the early 1990's. The RJR Nabisco leveraged buyout, and the acquisition of Kraft and General Foods (Post) by Phillip Morris in the 1980's merger wave fueled a drive to increase cash flows from dominant brands such as Nabisco Shredded Wheat and Post Grape Nuts. A not unrelated phenomenon was the expansion of private label RTE cereals (Cotterill and Haller, 1997; Cotterill et al., 1994).

Initially RJR/Nabisco chose to harvest the brand equity of Nabisco Shredded Wheat, elevating price and earning 29% of sales in operating profits in 1991. Phillip Morris/Kraft cooperated by raising the prices of Post Grape Nuts, Shredded Wheat's closest competition to earn 33 percent of sales as operating profits on the brand in 1991. In late 1992 RJR Nabisco attempted to sell what remained of Shredded Wheat to General Mills. The FTC indicated that they would challenge this acquisition by the number 2 cereal firm, so RJR withdrew and sold Shredded Wheat a few weeks later to Phillip Morris/Kraft, the third largest firm for the same amount, \$545 million (Cotterill and Haller, 1997). The FTC did not challenge this, however in January 1993 the State of New York did, and a full trial on the merits ensued in October 1994 (Janofsky, 1993).

The decision in this trial was crucial for the evolution of the industry in the 1990's and the genesis of the jawboning effort to lower cereal prices. Since Kraft prevailed at trial antitrust scrutiny has become more lax.<sup>1</sup> Ralston exited the production of branded cereals, by selling its

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<sup>1</sup> At least one industry analyst would disagree with this judgement that antitrust scrutiny been relaxed. J. Mehring, Salomon Smith Barney writes: "The regulatory environment has not been favorably disposed to seeing this category consolidated, probably because of the role of cereal in children's nutrition and the perception of historical price gouging in the category. As an example, General Mills had an extremely difficult time in the review process to win FTC approval of its 1997 purchase from Ralcorp of the CHEX cereal brands, which represented just 2.2 share points on a volume basis." (Mehring, p. 7).

Chex brands to General Mills in January 1997, a repeat of the Shredded Wheat event that the federal and state antitrust now approved. ConAgra, a powerful food manufacturer with the ascendant Healthy Choice line of nutritious food choices, had planned to enter the breakfast cereal industry by building a cereal plant, a very rare event in the evolution of this industry. Kelloggs in an equally unprecedented move opted in 1994 to joint venture with Congra, license the Healthy Choice brand name, and produce a line of “Kelloggs Healthy Choice” cereals. The irony of this move can only be appreciated when compared to the industry’s vehement opposition to one of the major proposals for relief in the shared monopoly case: the licensing of leading brand names and product formulas to entrants to foster entry and competition. Today we have only four large branded cereal manufacturers, Kelloggs, General Mills, Post, and Quaker, and four firm seller concentration remains above 80 percent.

The arguments presented at the Kraft Nabisco trial and the judge’s decision are discussed in detail in subsequent papers in this forum by the Grocery Manufacturers of America, Cotterill, and Kahn. The jawboning effort to lower cereal prices occurred because of the failure of this trial to provide relief to consumers. Thus a brief summary of the opposing viewpoints at trial are useful as an introduction to this forum. On pure market share grounds as stated in the Federal Merger Guidelines (Dept. of Justice, 1992) the Shredded Wheat merger was of concern. The premerger Herfindahl Hirschman Index (HHI) was 2300, well above the 1800 point in the Guideline whereafter “challenge is likely,” and the increase in the HHI was approximately 100 points, just at the threshold level for concern. Post cereals, the third largest firm with 12 percent of the market, was only acquiring the sixth firm with 3 percent of the market, however concentration and barriers to entry are both high. In a rare move the court appointed Professor Alfred Kahn as its economist to listen to opposing economic presentations and render an

economic opinion. Professor Daniel Rubinfeld, currently serving as the Assistant Attorney General for Antitrust Economics in the U.S. Dept. of Justice, served as Kraft's expert economist. I was the same for the State of New York.

As Professor Kahn explains in the paper presented in this forum, he found that the industry did not compete on price, but felt that forcing Kraft to divest Nabisco Shredded Wheat would not improve the likelihood of price competition. The State of New York presented the first point and maintained that divestiture would improve price competition. The state's argument, as documented in Cotterill and Haller (1997) was based in part upon empirical evaluation of the new unilateral theory of market power in differentiated product markets that subsequently has gained stature at the Justice Department (Shapiro, 1995) and FTC (Baker, 1996). Although the federal agencies have subsequently used this approach in crafting consent decrees (Shapiro, 1995), to date our analysis in the Kraft Nabisco matter is the only presentation at trial in a federal court. Of the old school, Professor Kahn was skeptical of statistical analysis of any sort for adjudicating a merger, and the judge rejected our unilateral effects analysis as unreliable.

The State of New York also argued that Professor Kahn's conclusion, that there was little or no price competition in the industry and that the merger would not change this situation, was sufficient grounds for divestiture. They maintained that once a condition of high concentration and barriers to entry exist (and both sides accepted these facts) then, according to the case law (U.S. v. Philadelphia National Bank) the burden of proof in a merger case shifts. The defendants must prove that the merger will make the industry more competitive. Otherwise one has a "monopoly defense" for mergers in highly concentrated industries. In her decision, the judge sidestepped Professor Kahn on this issue by finding, as Kraft argued, that the industry was

competitive in many nonprice dimensions, and therefore the merger did not violate the Clayton Antitrust act standard of “substantially lessening competition” (State of New York vs. Kraft General Foods). As explained in Cotterill in this forum (Cotterill, 1999), at issue is whether the antitrust laws focus solely on price competition or whether nonprice competition such as advertising, toys in the box, and sponsorship of golf games for grocery product buyers are permissible under the antitrust laws as competitive tactics that benefit consumers.

As we were working on the Post Nabisco antitrust case in the summer of 1993 it became apparent that consumers and the news media had considerable pent up frustration over high cereal prices. Consumers clearly wanted more price competition. One simple fact crystallized consumer frustration: cereal prices, as reported by the BLS CPI, rose 71 percent from 1983 to 1991 almost double the 37 percent increase in overall food prices. Our research on this point was highlighted in a *New York Times*, Business Section cover page article, “Waking Up to Higher Cereal Prices” on August 10, 1993 (Byrd, 1993). A deluge of phone calls from reporters and concerned citizen groups followed. The most interesting phone call, however, was from Anthony Hebron, Vice President for Public Relations at Kellogs. Mr. Hebron requested our price information for a report to the Kelloggs board of directors on consumer dissatisfaction with high cereal prices. Cereal companies were beginning to consider whether they had gone too far with “designer” cereals and a “let them use coupons” strategy reminiscent of Marie Antionette’s “let them eat cake” dictum on the eve of the French Revolution. There was a clear opportunity to mobilize public sentiment for rigorous antitrust enforcement, and to shift purchase patterns away from high priced cereals, thereby breaking the price-promotion spiral.

During late 1993 and early 1994 working with Policy Center Staff Andrew Franklin and Lawrence Haller, I prepared an extensive report (100 pages) on the noncompetitive pricing

practices of the cereal industry (Cotterill et al., 1994). The intent was to present this paper at a symposium titled, “Profitability of Food Manufacturing” at the August 1994 annual meeting of the American Agricultural Economics Association, and to release it to the press as a source book for consumer oriented stories on high branded cereal prices the need for rigorous antitrust enforcement and the need for more lower priced private label cereals. In fact it was never presented or released because the Phillip Morris Corporation threatened to sue us for libel if we did so. Phillip Morris reviewed this report at our request because we wanted to be absolutely certain that only publicly available information from the antitrust case was being used. This was in fact true, but the company considered the report’s analysis of harvesting and tacitly collusive pricing to be libelous and threatened to sue if we distributed it to the public. When a 55 billion dollar corporation threatens a college professor, it is effective. (What would your significant other say?) The paper was introduced in the antitrust case, but due to a protracted argument after trial over the unsealing of trial documents, it was not unsealed and publicly available as part of the court record until the Fall of 1997.

Phillip Morris has a reputation for threatening libel suits to suppress or channel research publication if it thinks it damages its business. Their move against *CBS 60 Minutes* for stories on cigarettes is well known. Less well known is the threat to sue University of Wisconsin Agricultural Economics Professors Bruce Marion and Willard Mueller for libel in May 1996 if they published their study of Phillip Morris/Kraft’s conduct on the National Cheese Exchange without giving the company an advance copy and allowing them to include a response. However the Wisconsin Progressive Tradition served professors Marion and Mueller well. With the full support of the university, and state government they released their study as planned and the

corporation acquiesced. A Congressional Hearing followed which aired all sides of the issue (Subcommittee, 1996).

Returning to breakfast cereal, our situation called for an innovative approach because the University of Connecticut and the faculty union refused to enter and neutralize the libel threat. During the Fall of 1994 at the end of a very rancorous and hard fought trial it was clear that the judge's decision (issued in February 1995) would be in favor of Kraft (State of New York v. Kraft General Foods). Antitrust enforcement would not provide consumers even a modicum of relief from high cereal prices via a new entrant into this industry. We needed an alternative approach and we needed some heavyweight allies. The key points from the alleged libelous paper and court testimony were repackaged in a 24 page memo to Congressman Samuel Gejdenson (D-CT) (Cotterill, 1994). Congressmen cannot be sued for libel. It clearly spelled out a jawboning strategy that might lead to lower cereal prices. Quoting from that memo:

“The truly challenging issue is how could one devise public policies or incentives that would change the industry's conduct in a fashion that would make consumers happier... I don't think any economist, liberal or otherwise, would suggest... intervention in the breakfast cereal industry.

A more effective remedy that takes advantage of market forces might be simply to generate information and publicity through hearings on the industry's performance and conduct. This industry is extremely sensitive to its public image and might very well change some of its competitive tactics towards providing lower price options for American consumers in response to such information and publicity. If consumers knew, for example, that Post spent 34 percent of its revenues for Post Grape Nuts on marketing expenses and also enjoyed a 33 percent profit sales margin in 1991, perhaps they would boycott the product (Cotterill affidavit, state of New York v. Phillip Morris, Para 40, February 5, 1993). If Congress investigated the pricing and profitability of this industry ... the response to such publicity would be explosive.” (Cotterill, 1994)

Congressman Gejdenson and Senator Charles E. Schumer, at the time a ranking Democrat on the House Judiciary Committee with oversight authority over antitrust enforcement, agreed to attack the industry's noncompetitive price conduct by holding congressional forums,

and embarking on a media campaign to inform consumers about high branded cereal prices and the lower priced private label alternative.<sup>2</sup> At a very well covered national press conference in Washington on March 7, 1995 they released their white paper study “Consumers in a Box: A Consumer Report on Cereal”. The media response was rapid and persistent. The Congressman appeared on several national news shows including the *Today Show*. I debated with cereal industry spokespersons in live TV interviews on programs including *ABC Good Morning America*, and the *Phil Donahue Show*. I also appeared with Senator Schumer opposite industry spokespersons on *ABC 20-20*, and a CNBC four part documentary on cereal pricing.<sup>3</sup> Professor John Connor, Purdue University spoke on NPR/All Things Considered, and Professor Ronald Curhan, Boston University appeared on PBS MacNeil/Leher. Hundreds of newspaper and magazine stories appeared during 1995 and 1996.

One year later the Congressmen organized a Congressional Cereal Pricing Forum. The industry was invited to participate. They attended the Forum, but refused to speak. By March 1996 it was clear consumers were listening to our message. They ate 145 million fewer boxes of branded cereal in 1995 than in 1994. This major volume growth reversal was due to increased private label consumption (up 9%) and switching to other breakfast foods (Gejdenson and Shumer, 1995).

Five weeks later on April 15, 1996 the year long jawboning effort came to fruition. Post Cereals cut its cereal prices by 20 percent.

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<sup>2</sup> The Congressman was in a battle of his own. In the 1994 republican/Gingrich sweep he won reelection by two votes, so the votes cast by my wife, my one coauthor who lived in the district, and me made the difference. A few months later after a recount he won by 21 votes. Had he lost the election this jawboning campaign would not have happened. Ultimately, it helped him win reelection in 1996 by over 5,000 votes.

<sup>3</sup> Videos of these shows are available from the author. They are excellent teaching aids for undergraduate marketing and food policy classes because they show the debate as a visual and “live” event.

In summary, jawboning is very challenging, but it has high potential pay off. The final paper in this forum estimates that the industries shift to lower prices saved consumers at least 1.098 and possibly as much as 2.4 billion dollars up to March 1, 1998. Even if cereal prices resume their upward trend, consumers will continue to receive benefits from the shift down in the price trend line that would amount to hundreds of millions of dollars annually.

To be this successful jawboning must catch an industry at a time when hubris and market power have extended pricing to questionable levels. This clearly was the case for breakfast cereal in early 1995. To be successful jawboning must also be firmly grounded in accurate, understandable, factual analysis of the industry's monopolistic pricing. The lead spokespersons must have credibility, access to the national news media, and influence on government policies. Unsubstantiated claims of poor performance or speculative projections can quickly backfire. We stuck to the hard facts. The firm that threatened to sue us for libel if we publicly talked about high cereal prices and noncompetitive price practices led the shift to lower prices. The RTE breakfast cereal industry, an industry quite impervious to antitrust initiatives, ultimately did respond to jawboning and national media pressure for lower prices. In fact the leading firms in the industry have yet to recover from the continuing shift in consumer preferences towards cheaper breakfast cereals or alternative breakfast foods.

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