CT-99/

THE COMPETITION TRIBUNAL

IN THE MATTER OF an application by the Commissioner of Competition pursuant to sections 92 and 105 of the *Competition Act,* R.S.C. 1985, c. C-34;

AND IN THE MATTER OF the merger of British American Tobacco p.l.c. and Rothmans International B.V. whereby British American Tobacco p.l.c. will acquire, *inter alia*, indirect control of Rothmans Inc. and thereby the controlling interest of Rothmans Inc. in Rothmans, Benson & Hedges Inc.;

B E T W E E N:

THE COMMISSIONER OF COMPETITION

Applicant

- and -

BRITISH AMERICAN TOBACCO p.l.c.

Respondent

STATEMENT OF GROUNDS AND MATERIAL FACTS

I. <u>INTRODUCTION</u>

1. The Commissioner of Competition (the "Commissioner") brings this application for a consent order on the grounds that the merger of British American Tobacco p.l.c. ("BAT") and Rothmans International B.V. ("Rothmans International"), whereby BAT will acquire, *inter alia*, indirect control of Rothmans Inc. ("Rothmans") and thereby its controlling interest in Rothmans, Benson and Hedges Inc. ("RBH") (the "merger") would, in the absence of the

draft consent order (the “DCO”), be likely to prevent or lessen competition substantially in the market for manufactured cigarettes and in the market for fine cut tobaccos throughout Canada.

2. The Commissioner, with the consent of BAT, respectfully submits for approval a DCO that, if implemented, will eliminate any such effect upon competition arising from the merger.

3. The statement of grounds and material facts herein forms the basis of the application brought by the Commissioner with the consent of BAT. The Commissioner has alleged certain material facts, and the respondent does not agree with all the facts alleged but does not contest the statement of grounds and material facts for the purposes of these applications and any proceeding initiated by the Commissioner relating to this consent order including an application to vary or rescind. The respondent consensually attorns to the jurisdiction of the Competition Tribunal solely for the purpose of these applications.

II. THE PARTIES

THE COMMISSIONER

4. The applicant is the Commissioner of Competition, appointed under s. 7 of the *Competition Act*, R.S.C. 1985, c. C-34 and, as such, is the person authorized to make this application.

BRITISH AMERICAN TOBACCO p.l.c

5. BAT is a corporation registered in England and Wales. BAT is a holding

company with interests in a number of companies which manufacture, distribute and sell more than 240 brands of cigarettes and other tobacco products in Canada, Europe, the United States, Asia and other territories throughout the world. Major international brands include *State Express 555*, *Lucky Strike, Kent* and *Benson & Hedges*. As BAT is a holding company, it is not engaged in operational activities.

IMASCO LIMITED

6. BAT's interest in the Canadian tobacco business is through its indirect ownership of 42% of the voting shares of the publicly traded company Imasco Limited ("Imasco") of Montréal, which is listed on The Toronto Stock Exchange, The Montréal Exchange and the Vancouver Stock Exchange. Imasco has three principal businesses with operations in Canada: (i) Imperial Tobacco, a division of Imasco, and its subsidiary Imperial Tobacco Limited (collectively "Imperial" of which Imasco owns 100%); (ii) Imasco Financial Corporation, through which Imasco holds its interest in The Canada Trust Company; and (iii) Shoppers Drug Mart Limited.

7. As a major Canadian consumer products and services company, Imasco operates through a number of divisions, including Imperial, which is Canada's largest tobacco enterprise. Imasco also has a number of significant businesses unrelated to tobacco. Headquartered in Montréal, Imperial manufactures and distributes a full range of tobacco products, including manufactured cigarettes, cigars and fine cut tobacco. Imperial Leaf Tobacco, a company division based in Aylmer, Ontario, purchases and processes leaf tobacco for Imperial and for export. Other processing facilities are located in Joliette and LaSalle, Québec, while tobacco production and packaging facilities are located in Montréal and Guelph, Ontario.

8. For the year ended December 31, 1998, Imperial's sales revenue, net of tobacco taxes and duties, was $1.8 billion and earnings from operations were $815 million.

9. Imperial has a large customer base in Canada. As its principal market, sales in Canada accounted for 96.2% of revenues in 1997. The company also exports leaf tobacco to 20 foreign customers located mainly in England and the U.S.. It also exports tobacco products to the U.S. through its two distributors in the U.S., Philip Morris and ITL (USA) Limited (an affiliate of Imperial).

10. The best known manufactured cigarette brands produced and distributed by Imperial are *du Maurier* and *Player's*. Combined sales of these two brands (numbers one and two in popularity) account for almost 60% of the Canadian manufactured cigarette market. Other manufactured cigarette brands of Imperial include *Matinée* (the fourth largest selling brand in Canada), *Cameo, Avanti, Medallion* and *Peter Jackson,* which when combined with *du Maurier* and *Players* gives Imperial a total share of the manufactured cigarette market of some 70%. Fine cut tobacco brands include *Matinée, Peter Jackson, Player's, Sweet Caporal* and *Vogue*; pipe tobacco brands include *Old Port, Old Chum, Old Virginia and Sir Walter Raleigh,* and cigar brands include *Old Port, House of Lords, White Owl, Reas* and *Colts*. General Cigar Company in Montréal, a wholly-owned subsidiary of Imperial, manufactures and distributes cigars which are exported to some 30 countries.

11. Imperial purchases tobacco grown in Ontario and Québec and purchases approximately 1,500 packaging commodities from 60 suppliers located primarily in Canada, with some specialty items being purchased in the U.S. or

Europe. Imperial employs approximately 2,000 full-time employees and 350 seasonal employees.

ROTHMANS INTERNATIONAL B.V.

12. Rothmans International is the world's fourth largest international tobacco group. It is incorporated under the laws of the Netherlands and it is a holding company of a group of companies which are engaged in the manufacture, distribution and sale of tobacco products, including cigarettes, "roll your own" or fine cut tobacco, pipe tobacco and cigars. The Rothmans group has a strong portfolio of international brands, including *Rothmans, Dunhill, Peter Stuyvesant, Winfield* and *Pall Mall*. The Rothmans group is also represented in Western Europe, Africa, Australasia and a number of Southeast Asian markets. Its products are manufactured in over 30 factories and sold in over 160 countries and territories. Rothmans International is an indirect subsidiary of Compagnie Financière Richemont AG ("Richemont"), a Swiss public company which indirectly owns two-thirds of the Rothmans International share capital. The remaining one-third is indirectly held by Rembrandt Group Ltd. ("Rembrandt"), a public company in the Republic of South Africa.

RICHEMONT AND REMBRANDT

13. In addition to its indirect two-thirds share ownership interest in Rothmans International, Richemont has extensive interests in the luxury goods industry through its wholly owned subsidiary Vendôme Luxury Group, which owns a number of well known international brands including *Cartier, Alfred Dunhill and Montblanc*, as well as several prestigious Swiss watch brands.

14. In addition to its indirect one-third share ownership interest in Rothmans International, Rembrandt has investments in a wide range of other businesses,

including wines and spirits, mining, financial services and mobile communications.

15. Both Richemont and Rembrandt are effectively controlled by the Rupert family of South Africa.

ROTHMANS INC.

16. Rothmans Inc. ("Rothmans") is a public company with common shares traded on the Toronto, Montréal and Vancouver stock exchanges. Rothmans International indirectly owns 71.2% of the common shares of Rothmans. Rothmans manufactures and distributes a full range of tobacco products in Canada through its 60% owned subsidiary, Rothmans, Benson & Hedges Inc. ("RBH"). An affiliate of Philip Morris Companies Inc. owns the remaining 40% of RBH.

17. RBH has two manufacturing plants, located in Québec City and in Brampton, Ontario, and 13 sales offices located across Canada. Through these facilities, RBH manufactures and distributes cigarettes under a number of brand names, including *Rothmans, Craven "A", Benson & Hedges, Belvedere, Number 7, Mark Ten* and *Viscount*, which in total represent 93.8% of RBH's cigarette sales. The two major cigarette brand families are *Craven "A"* and *Rothmans*, which accounted for 19.7% and 20.4% respectively of RBH's total sales in 1996/97. Other cigarette brands include *Accord, Belmont, Dunhill, Sportsman, Canadian Classics, Peter Stuyvesant* and *Black Cat*. Fine cut tobacco brands include *Mark Ten, Craven "A", Rothmans, Sportsman, Number 7, Belvedere, Black Cat* and *Superoll 200* and pipe tobaccos include *Captain Black, Erinmore* and *Golden Dansk*.

18. Rothmans was incorporated in 1956 as Rothmans of Pall Mall Canada Limited to carry out manufacturing and distribution of Rothmans's tobacco and fine cut tobaccos in Canada. Effective September 30, 1985, Rothmans changed its name to Rothmans Inc. and on October 1, 1985, the company formed a wholly-owned subsidiary, Rothmans of Pall Mall Limited, to operate its tobacco business. In December 1986, Rothmans of Pall Mall Limited merged with Benson & Hedges (Canada) Inc., a subsidiary of Philip Morris, to form RBH.

19. Rothmans sales revenue for the year 1998 was $555.1 million and earnings were $67.6 million.

20. Attached as Schedule "A" is a corporate chart outlining the ownership by Rothmans International of its Canadian tobacco interests.

RJR-MACDONALD

21. RJR-Macdonald Inc. ("RJR") is the only other major participant in the tobacco industry in Canada. RJR has some 12% of the manufactured cigarette market and 18% of the fine cut tobacco market. RJR is owned by the U.S. firm RJR-Nabisco Inc. which has entered into an agreement (subject, among other things, to regulatory review) to sell RJR to Japan Tobacco. Financial information from RJR is unavailable because it is a wholly-owned subsidiary and reports on a consolidated basis with its parent.

III. THE MERGER

22. On January 11, 1999 the indirect shareholders of Rothmans International, Richemont and Rembrandt, and BAT announced that they had reached agreement on the terms of a proposed merger of BAT and Rothmans International. Under the terms of the agreement BAT will issue ordinary shares

and convertible redeemable participating preference shares to a company jointly owned by Richemont and Rembrandt. On a fully diluted basis, the new shares will account for 35% of the enlarged BAT group, 25% in ordinary shares and 10% in convertible redeemable shares. Richemont and Rembrandt have agreed to restrict their voting rights to 25% of the shares of the enlarged BAT group. The proposed transaction is subject to certain regulatory approvals and is targeted for completion in the second quarter of 1999.

23. As a result of the proposed merger, BAT will acquire indirect control of RBH, Imperial's largest competitor. BAT also indirectly owns 42% of the voting shares of Imasco, which owns 100% of Imperial. The remaining 58% interest in Imasco is widely held.

IV. COMPETITIVE ANALYSIS

PRODUCT MARKET

24. The tobacco industry in Canada is highly concentrated, with only three major tobacco companies -- Imperial, Rothmans, and RJR. The primary products produced by these companies are manufactured cigarettes, which represent some 90% of the sales of tobacco products in Canada, and fine cut tobacco (including tobacco sticks) used in "roll your own" products, which makes up another 8%. Other tobacco products including pipe tobacco and cigars are not considered in this analysis because they constitute only 2% of all tobacco products in Canada, there is limited substitution between these products and manufactured cigarettes and manufactured fine cut tobacco, and because BAT has agreed to divest its entire interest in RBH in any event.

25. Manufactured cigarettes are products that are generally similar in outward appearance and have the same intended use. They combine a large number

of common external characteristics related to their presentation, i.e., package sizes, length, packaging, diameter. They are offered in the market in various combinations of internal characteristics related to the tobacco blend, taste and flavor, tar content and nicotine level, as well as ventilation and filtration, which are normally identified with a brand (or member of a brand family). Brands are linked to image and quality level and are supported where possible by advertising and promotional activities.

26. Although the manufactured cigarette market may be segmented according to a number of the characteristics identified above, the sub-division of this market would in most cases not be meaningful. All major competitors offer a comprehensive portfolio of cigarettes that cover various product characteristics in order to meet the entire range of consumer preferences. The ingredients, methods of production, packaging, technology and distribution methods are largely similar for all types of manufactured cigarettes.

27. Fine cut or “roll your own” tobacco (which includes tobacco sticks) is a product offered as a pack of “loose” tobacco from which consumers can roll cigarettes themselves. Its physical and technical characteristics are different from manufactured cigarettes, and it is taxed at a lower level than manufactured cigarettes. Tobacco sticks are pre-portioned cylinders of tobacco that the consumer inserts into paper tubes in preparation for smoking. They have been included in the fine cut tobacco market definition due to their close substitutability to fine cut tobacco. While “roll your own” and tobacco stick products are used to perform the same function as manufactured cigarettes, and while some “roll your own” smokers do switch between them, the degree of substitutability between these products is limited.

GEOGRAPHIC MARKET

28. The geographic market for manufactured cigarettes and fine cut tobacco made in Canada is national, with the same brands of the same parties competing everywhere in Canada, but not having any significant sales outside Canada. The value of manufactured cigarettes and fine cut tobacco is high relative to the costs of transportation, and a price increase in one part of the country could be disciplined by shipments from another region. Although there are some sales of foreign manufactured cigarettes and fine cut tobacco in Canada, market penetration of foreign manufactured cigarettes and fine cut tobacco is very low. Canadian smokers are unlikely to consider switching to foreign brands in response to a small but significant increase in the price of Canadian manufactured cigarettes and fine cut tobacco, primarily because Canadian manufactured cigarettes use Virginia tobacco, which has a distinctive flavour compared to manufactured cigarettes sold in many other countries. This taste difference is significant when compared to U.S. cigarettes that are manufactured using a blend of tobaccos which may include flavouring additives. The geographic market does not include the U.S. and other countries.

COMPETITIVE IMPACT

Market Shares

29. Post merger, BAT will have indirect control of RBH. The RBH cigarette brands, including *Rothmans*, *Craven "A"*, *Benson & Hedges*, *Number 7*, *Mark Ten*, *Viscount* and *Belvedere,* accounted for approximately 18% of Canadian manufactured cigarette sales in Canada in 1998. Imperial accounted for approximately 70% of manufactured cigarette sales in Canada in 1998 through such brands as *du Maurier*, *Players* and *Matinée*.

30. In the fine cut tobacco market, Imperial is not as well represented as in the

manufactured cigarette market, with a market share of some 37% in 1998. RBH's share of the fine cut market was some 44% in 1998.

31. Post merger, Imperial and RBH brands together would account for approximately 88% of Canadian manufactured cigarette sales, based on 1998 figures. In the fine cut tobacco market segment the combined market share of Imperial and RBH would exceed 80%.

32. RJR has the remaining 12% of the Canadian manufactured cigarette market, and some 18% of fine cut tobacco market. Its major manufactured cigarette brands include *Export A* (the third largest selling brand in Canada), *Vantage* and *Macdonald*. As with other tobacco companies, RJR is unlikely to be able to expand its share substantially due to constraints on marketing and advertising.

33. The trend in market shares is depicted below:

Market Shares (%) Domestic Manufactured Cigarette Shipments 1994-1998

	1994	**1995**	**1996**	**1997**	**1998**
Imperial	65.4	67.6	67.6	69.3	69.9
RBH	20.2	20	19.5	18.5	17.9
RJR	14.4	12.4	12.9	12.2	12.2

Source: Canadian Tobacco Manufacturers Council

Market Shares (%) Fine Cut Tobacco Shipments 1994-1998

	1994	**1995**	**1996**	**1997**	**1998**
Imperial	43.7	38.4	34	34.1	37.1

RBH	30.6	40.2	48.2	47.6	44.3
RJR	25.7	21.4	17.7	18.2	18.6

Source: Canadian Tobacco Manufacturers Council

Barriers to Entry

34. There are significant barriers that inhibit or prevent new competitors from entering these markets - there have been no major entrants in the Canadian tobacco industry in some 40 years. Such barriers make it unlikely that potential entrants would enter the Canadian market for either product in response to a significant but non-transitory price increase. Brand image is very important, particularly in the manufactured cigarette market. A new entrant into Canada would have to incur significant costs, mainly through advertising and promotion, to establish a brand. The success of a new brand is not guaranteed and these costs would be sunk, as they could not be retrieved in the event of failed entry.

35. The manufacture of cigarettes and fine cut tobacco is also characterized by significant economies of scale which include significant start-up costs for manufacturing facilities. The combination of sunk costs, economies of scale and regulatory restraints makes entry into the market in response to a post-merger price increase very unlikely.

36. In 1995, the Supreme Court of Canada decided that some sections of the *Tobacco Products Control Act* were unconstitutional. (*RJR-Macdonald Inc. v. Canada (Attorney General),* [1994] 1 S.C.R. 311, 111 D.L.R. (4th) 385, 54 C.P.R. (3d) 114, (*sub nom. RJR-MacDonald Inc. c. Canada (Procureur général) 164 N.R. 1, 60 Q.A.C. 2*41.) On March 31, 1997, Parliament enacted

the *Tobacco Act*, which restricts product manufacture, access (particularly by young persons), labeling and promotion. The new Act bans virtually all forms of tobacco advertising, including the sponsorship of sporting and cultural events. The three major tobacco companies have challenged, in the Québec Superior Court, the constitutionality of various sections of the Act; however, depending on the eventual resolution of this litigation, restrictions on tobacco advertising and on promotion of sports and cultural events by tobacco companies will likely make it even more difficult to establish a brand, and could increase the costs of entering the market.

Substitute Products

37. Few, if any, products can directly substitute for manufactured cigarettes. In Canada, fine cut tobacco is not, on a national basis, a significant substitute for manufactured cigarettes.

Foreign Competition

38. Import competition in the manufactured cigarette market and fine cut tobacco market is very low. Canada is a so-called "Virginia" market where grades of tobacco are combined to achieve the products' distinctive taste. The U.S.A. is a "blended" market where casings and flavorings may be used in the manufacturing process. These differences, which impact on taste and flavor, help explain the lack of foreign brands competing in Canada.

39. As well, the principal indirect shareholders of each of Imperial, RJR and RBH also have interests in large American tobacco manufacturers which are unlikely to enter Canada to compete with the Canadian companies.

40. Finally, the two remaining U.S. manufacturers of any significance, Lorillard and

Liggett, are not likely to want to supply Canada because of the taste differences, declining consumption, the effective health lobby, the high level of regulation and the high costs associated with establishing a manufacturing presence in Canada.

Effective Remaining Competition

41. The only other significant remaining competition in Canada is RJR, which holds some 12% share of the of the manufactured cigarette market and 18% of the fine cut tobacco market. RJR's share of the manufactured cigarette and fine cut tobacco markets has declined over the past five years. It is not presently clear what impact Japan Tobacco's acquisition of RJR will have on its ability to compete in Canada over the next two years.

42. Post-merger, BAT's indirect stake in both Imperial and RBH would create a significant financial incentive that would affect BAT's decision-making vis-à-vis both companies. This situation would likely limit significantly or curtail the current state of competition between Imperial and RBH.

Change and Innovation

43. The manufacturing, sales and distribution of manufactured cigarettes and fine cut tobacco is a mature industry which is not characterized by significant technological change or innovation, other than reductions in the levels of tar and nicotine. As such, this issue is not considered to be significant.

Interdependence

44. Price rivalry within the industry over the past 15 years has been relatively tame.

Imperial is the leader and its decisions on prices tend to be routinely followed by the other two companies. There has not been a price war since 1986. In the event that the merger were to proceed the risk for interdependent behavior would be increased.

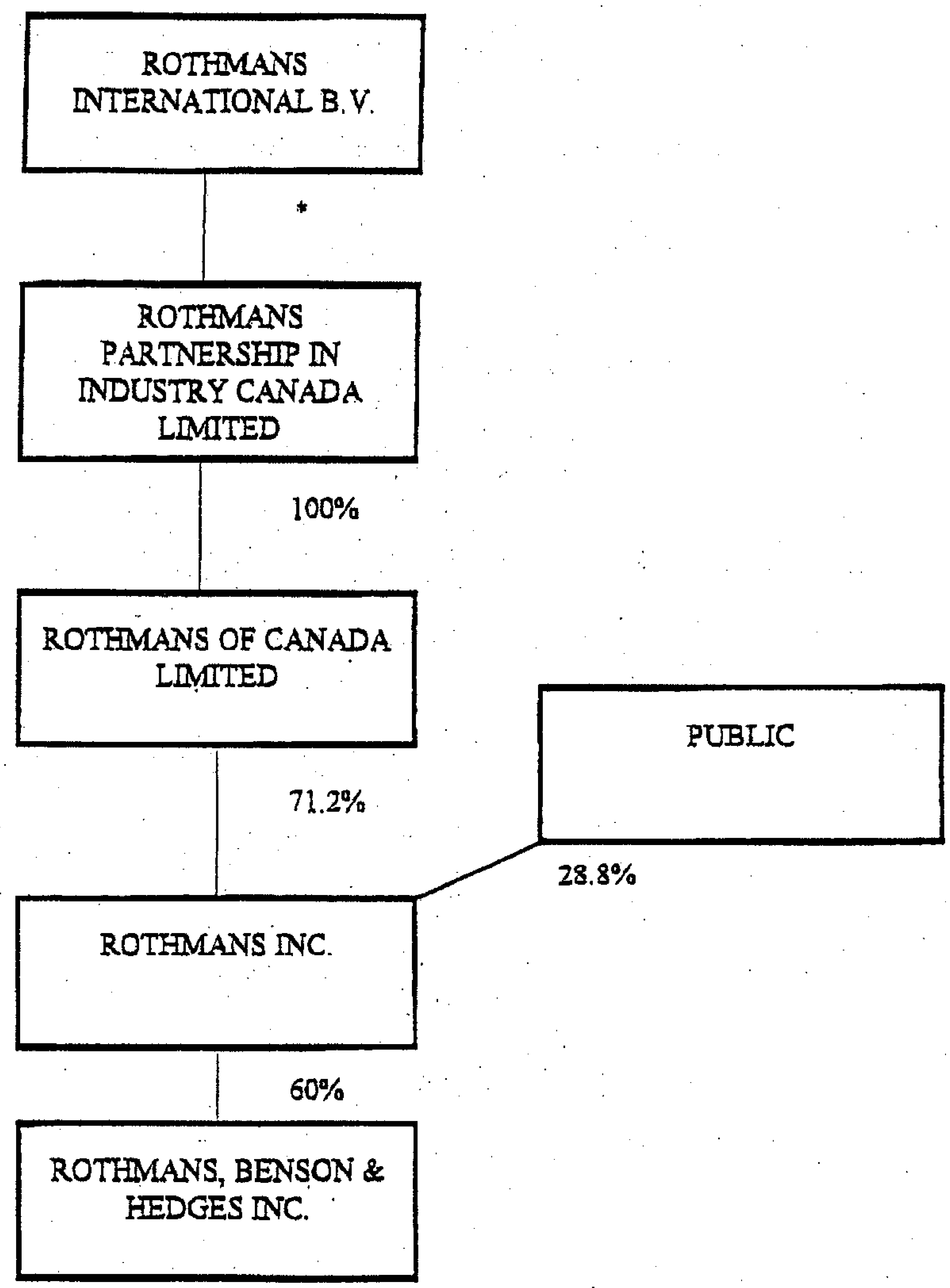
V. CONCLUSION

45. Given BAT's stake in Imasco and thereby its indirect economic interest in Imperial, there would be a financial incentive created by the merger that would affect BAT's decision making vis-a-vis RBH, one of Imperial's competitors. In light of that and the high market shares, the high barriers to entry into Canada, the lack of substitute products**,** the insignificant foreign competition in the domestic manufactured cigarette and fine cut tobacco markets, and the other Section 93 factors set out above, the Commissioner has concluded that, in the absence of the DCO, this transaction would likely result in a substantial lessening of competition in these two markets. BAT has indicated its willingness to proceed to the Competition Tribunal to seek a consent order that will result in the divestiture by BAT of the entire interest in RBH which BAT will acquire through the merger between BAT and Rothmans International.

46. The result of the DCO will be to eliminate a substantial lessening or prevention of competition in the Canadian manufactured cigarette and fine cut tobacco markets that will likely arise as a consequence of the merger.

SCHEDULE "A"

Rothmans Canadian Outline Structure Chart as at April 30, 1999



*intermediate wholly-owned Dutch interests

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BETWEEN:

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Respondent

STATEMENT OF GROUNDS AND MATERIAL FACTS

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