"Assessment of U.S. Merger Enforcement Policy"

Testimony Before the Antitrust Modernization Commission

David T. Scheffman

November 17, 2005

I. Introduction

Thank you for the opportunity to appear here today to discuss issues related to Merger Enforcement. I have been involved in Merger Enforcement for over 25 years, including over 13 years in various positions at the Federal Trade Commission. I began at the FTC in 1979. At the beginning of my experience at the FTC I was involved in Merger Enforcement when very few significant horizontal mergers in concentrated industries were even attempted. For example one of the first major merger investigations I worked on at the FTC was Exxon's acquisition of Reliance Electric, a merger that was neither horizontal nor vertical. I became the head antitrust economist at the FTC when the FTC began to implement the 1982 DOJ Merger Guidelines. I became the Director of the Bureau of Economics in 1985, a position I held until the Fall of 1988. In June of 2001 I returned as the Director of the Bureau of Economics and stayed until September of 2003.

During the period 1989-1999 I was the Justin Potter Professor at the Owen Graduate School of Management at Vanderbilt University. In that position I created the MBA and Executive MBA programs on Business Strategy, and taught courses on business strategy, marketing, distribution, pricing, and intellectual property management and valuation.

Since 1999 (other than my second stint at the FTC) I have been Adjunct Professor at the Owen School and have been affiliated with LECG, a consulting firm.

As a business school professor, business consultant, FTC employee, and economic consultant, I have long been involved in merger analysis, both from a business and antitrust perspective. Before, during, and after my first stint at the FTC, I have published a number of articles on the economics and policy of merger enforcement.[1]

II. Overview of the History Under HSR

As an overview, I can state with great confidence that relative to 1979, U.S. merger enforcement policy has been dramatically more effective in "ensuring competitively operating markets without unduly hampering the ability of companies to operate efficiently and compete in global markets." As I have written and has been noted elsewhere, horizontal mergers can be very important in achieving efficiencies of many kinds that could not otherwise be achieved. There are few if any knowledgeable people that would defend the pre-1982 merger enforcement policy in the U.S. I also am convinced that, in large part, the history since 1982 has been one of gradual improvement in merger enforcement policy from both the perspective of economic efficiency and consumer welfare.

For example, the FTC's very lengthy investigation of the General Motors/Toyota joint venture during the early 1980s, which was allowed to proceed in what was then a

[1] I believe that the following articles that I have authored or co-authored are particularly relevant to my testimony: "Making Sense of Mergers," Antitrust Bulletin, Vol. 38, No. 3, Fall 1993, pp. 715-740; "Ten Years of Merger Guidelines: A Retrospective, Critique, and Prediction," Review of Industrial Organization, Vol. 8, No. 2, 1993, pp. 173-189; "Interview with David Scheffman, the FTC's New Director of the Bureau of Economics," www.AntitrustSource.com, January 2002; "20 Years of Merger Guidelines Enforcement at the FTC: An Economic Perspective," (with M. Coate and L. Silvia) 71 Antitrust Law Journal, 277-318.

highly contentious and controversial decision, would have by the 1990s and since probably been uncontroversial for mainstream antitrust commentators. The statements of dissenting Commissioners in that matter are certainly instructive as to how far we have come.

As I have written elsewhere,[2] this single decision was very important for the development of sound merger enforcement policy, generally. For example, given the evolution of the global automobile industry since the 1980s, that investigation and decision make clear the important potential tradeoffs between short run concentration indicia and the ability of mergers and joint ventures to attempt to facilitate increases in competition in all dimensions.

Each of the revisions in the Merger Guidelines since 1982 has advanced the analysis. This is particularly true of the 1992 Merger Guidelines which in many ways firmed up the economic underpinnings of the 1982 Guidelines.[3]

III. What Do the Agencies Do Best?

Mergers in industrial products and services industries that have a limited number of customers and for which there are clear and largely <u>representative</u> opinions of sophisticated customers as to the competitive implications of the proposed merger are for many reasons are the mergers for which the agencies have a high "success" rate. The agencies, rightfully in my view, rely substantially on customer opinions. When the

---

[2] "20 Years of Merger Guidelines Enforcement at the FTC: An Economic Perspective," (with M. Coate and L. Silvia) 71 Antitrust Law Journal, 277-318.

[3] I have also criticized the 1992 Guidelines, still rightfully so in my judgment, on the mischief they would and did create in the area of unilateral effects. I also criticized them for analytical flaws in their analysis of barriers-to-entry. *See* "Ten Years of Merger Guidelines: A Retrospective, Critique, and Prediction," Review of Industrial Organization, Vol. 8, No. 2, 1993, pp. 173-189.

customers are sophisticated and the opinions are largely uniform and clearly related to bonafide competitive issues, that is one sound basis for merger enforcement decisions. (Of course, although customer input is one important factor, a market must still be properly delineated and bases of adverse competitive effects must be tested against all of the available evidence). An ancillary justification of reliance on customer opinions of the kind I have been discussing here is that a merger for which the customers are adverse is generally unlikely to be financially successful, independent of the antitrust issues.

IV. Where Are the Problems with Recent and Current Merger Enforcement?

Although I am convinced that the mistake rate is not high (and the mistakes made in the direction of not attempting to block or remedy what actually is a competitively problematic merger are quite low), as a general matter, the further the agencies get from mergers involving industrial products and services with a limited number of customers with representative opinions, the more likely it is that the agencies make a mistake . (And the mistakes in my view are predominately in the direction of blocking or remedying a merger that is probably not, in fact, competitively problematic). Nonetheless, I believe that the mistake rate is pretty low, although improvement is still warranted. One salutary factor of considerable importance, is that the agencies are very responsive to adverse court decisions. Thus, I strongly believe that adverse decisions like *Oracle* and *Arch Coal*, independent of the merits of those two matters, will lead to significant improvements in agency analyses and decision making.

I will discuss next the general categories of issues that I believe that lead to mistakes.

A. Legalistic Environment

Given our legal system, I suppose that it is not surprising that our merger investigations are highly legalistic compared to other jurisdictions. I have seen no convincing evidence that the approach we use in the U.S. is worth the cost. Furthermore, the case put forward by the agencies in court is often markedly different in some key respects from the "internal case." For example, although econometric evidence is sometimes important in agency decision making, it is relatively rare that the agencies use such evidence in court. And the legal cases inside and at court also sometimes markedly differ. For example, from the outside, it appeared to me, for example, that the internal case for *Oracle/People Soft* was quite different from the case presented in court.[4] I will also comment presently on market definition, that sometimes in my experience is given relatively short shrift with the agencies compared to what the agencies have to do to actually litigate a case.

"Hot documents" get more weight sometimes than they deserve. The agencies reliance on "hot documents," however has been strengthened by the importance courts have placed on this sort of evidence. It is discouraging for an economist that in *Staples/Office Depot*, although two first rate econometricians testified, they apparently cancelled each other out, and the court apparently relied predominantly on "hot documents." Economics and economists have to do better in providing input to the fact finder (and agency decision makers). This is an important issue currently being addressed by the ABA Antitrust Section's Taskforce on Economic Evidence.

---

[4] I was an economic consultant to Latham and Watkins in the litigation.

B. "Transparency"

The FTC release of the "secret Guidelines data" and further information has been a substantial contribution to increased transparency.[5] However, I spoke out forcefully in my last stint at the FTC of the specific and general desirability of greater transparency. I even thought that I had enshrined transparency at the FTC through the Best Practices for the Bureau of Economics[6] that was supposed to be fulfilled in spirit also on the legal side of merger investigations. However, my biggest "failure" in my last stint was that there was little progress on implementing a durable policy with respect to transparency. I am convinced that the agencies would make better decisions if there were more transparency. I also believe, and I saw concrete evidence of it at the FTC, that the agencies and the specific investigation staff actually benefit in both efficiency and work load from transparency.

The reasons why this policy has not developed are both human and organizational. Some investigation staffers do not see the benefits of transparency. In some investigations that parties and/or their lawyers (and economists) play "hide the ball," or worse,[7] themselves, which is not the *quid pro quo* that should be required for agency transparency. In addition, investigation staff sometimes does not know what their management's view of various conclusions will be, so in some sense, they are not sure what to be transparent "about." Finally, senior management at the agencies are generally transitory. It is very difficult to make lasting change in process. I continue to strongly

---

[5] *See* http://www.ftc.gov/ops /2004/2/horizmerger.htm and http://www.ftc.gov/os/2005/02/0502economicissues.pdf.

[6] http://www.ftc.gov/be/ftcbebp.pdf.

[7] *See*, Chairman Majoras comments in her speech at the annual ABA meetings this year, http://www.ftc.gov/speeches/majoras/050806abamtg.pdf.

believe, however, that transparency makes the staff job easier. In particular, the result of transparency is often that "nothing credible comes back across the net," so that staff gains additional assurance that their conclusion and bases are sustainable.

To institute a policy of more transparency will require some thought and specific actions. It cannot begin until the leadership of the two agencies make transparency a priority that is communicated to staff and to the "outside" and that is rigorously implemented within the agencies.[8]

At a minimum, more detailed explanations for agency decisions, as it routinely done in the EU and was done by the FTC, for example, in the "cruise ship matter," would clearly be beneficial. The current joint project of the DOJ and FTC on merger enforcement "narratives" is also welcome.

C. Remedies

I believe that the antitrust agencies are sometimes too demanding in what they require as adequate fix to what they have concluded is a competitively problematic transaction. This problem has been reduced from the 1980s and 1990s (although it continued to some extent at the FTC during my last stint). I predict that this problem is going to some extent be "fixed" because District Courts appear quite prepared to consider a proposed fix in agency litigation against a proposed transaction, and all the signs are that a court will not use the same restrictive standards that are sometimes imposed by the agencies.

---

[8] For example, meetings with Bureau Directors and Commissioners at the FTC, and with Deputies and the AAG at DOJ should begin with: "Staff's concerns and bases are X, Y, Z – is that your understanding?" If there is credible evidence that the parties did not understand that, there would need to be remedies to make sure that "it" does not happen again. Agency leaders should also find out when the parties found out what staff's concerns and bases were.

D. Market Definition

The Merger Guidelines, perhaps after many articles on this topic, are very clear as to the basic economic test for market definition. In the early years of merger enforcement under the 1982 Guidelines, the focus of the investigation by agency lawyers was often asking customers how they would respond to hypothetical price increases. For many reasons that approach was unsatisfactory. Although the importance of this line of investigation has dramatically fallen over time, one of the reasons why this line is unsatisfactory continues to some extent today. Specifically, even to the extent the answers to such hypothetical questions are "accurate," the answers do not answer the Guidelines' market definition question, which is how much sales would be lost in response to the "small but significant and nontransitory" increase in price ("SSNIP").

Many customers, particularly in industrial products, are likely to be inframarginal, that is customers that might not alter their purchases significantly in response to a SSNIP. Of course, the Guidelines test is based on *marginal* customers and sales. It is quite possible for the typical customer to be fairly inelastic but that "market demand" is too elastic to pass the Guidelines hypothetical monopolist test. This is particularly the possible to be the case when there are large sophisticated customers.[9]

The result has been that in cases like *Sungard* and a number of other cases, judges understand the logic of the Merger Guidelines market definition methodology and apply it to the available facts, and agencies have sometimes not been able to sustain their

---

[9] *See*, for example, David Scheffman and Pablo Spiller, "Buyers, Market Power, and Market Definition," in *The Economics of the Antitrust Process*, M. Coate and A. Kleit, eds., Kluwer Academic Publishers, 1996, pp. 117-134; and David Scheffman and Pablo Spiller, "Buyers' Strategies, Entry, and Competition" *Economic Inquiry*, Vol. 30, No. 3, July 1992, pp. 418-436.

burden. I believe that as a general matter, probably since the *Staples/Office Depot* matter, the agencies have focused too much on theories of potential effects, which has in some cases led to not giving sufficient attention to the factual basis for conclusions about market definition. It can easily be understood that for complex products (*e.g.*, those involved in *Sungard*, and *Oracle*, for example), if there are not a relatively small number of customers and customers do not have uniform opinions, that market delineation must be particularly important in enforcement decisions.

This is an issue in which economists and economics have not been particularly helpful. The government must prove a market, which is not helped when economists (and sometimes, lawyers) want to focus predominately on theories of competitive effects. I am strongly of the view that sensible and administrable merger enforcement must be based on proper product and geographic market delineation. Economists' models are a complement, not a substitute for the richness of evidence and analysis that is required for proper market delineation. Despite the hostility of many economists to so-called "Critical Loss" analysis, such an analysis, used properly in a particular situation clearly is "the" market definition methodology of the Merger Guidelines.[10]

Finally, I agree wholeheartedly with former Chairman Muris's statement in connection with the Genzyme/Novazyme matter about the untenability of "innovation markets."[11]

---

[10] *See* David Scheffman and Joseph Simons, "The State of Critical Loss Analysis: Let's Make Sure We Understand the Whole Story," *Antitrust Source*, November 2003; Michael Katz and Carl Shapiro, "Further Thoughts on Critical Loss," *Antitrust Source*, March 2004; and Daniel O'Brien and Abraham Wickelgren, "The State of Critical Loss Analysis: Reply to Scheffman and Simons," *Antitrust Source*, November 2003; March 2004.

[11] http://www.ftc.gov/os/2004/01/murisgenzymestmt.pdf.

E. Efficiencies

This is an issue for the following panel. First, I think that the FTC Bureau of Economics Roundtable on "merger efficiencies" provided a lot of valuable information that I am not sure has been digested within or outside the agencies.[12]

Second, although I was not involved in any way with the matter, the "Baby Food" case was not a positive development for the role of efficiencies. However, the courts bear the primary blame for this result.

Finally, from my perspective as a business strategy professor, the economic motivations for horizontal mergers and the implications of those motivations are not fully absorbed by the antitrust agencies or of the antitrust "community," generally.[13] That is not to say that business strategy "stories" should be necessarily given any weight, particularly when there is compelling evidence of likely price increases following the proposed merger, but for those mergers in which the fundamental evidence is largely structural (*e.g.*, a "4-to-3" merger plus some "warm" documents), a broader understanding of potential merger benefits might lead to better enforcement decisions. And with respect to antitrust-focused efficiency analyses, I believe that the agencies are sometimes unrealistic in the standards of proof required – standards that are far in excess of what is utilized to make a decision that a proposed merger is problematic.

---

[12] *See* http://www.ftc.gov/be/rt/mergerroundtable.htm.

[13] *See*, for example, my article "Making Sense of Mergers," *Antitrust Bulletin*, Vol. 38, No. 3, Fall 1993, pp. 715-740. I think that there have been modest improvements since I published that article in 1993.

F. Economic Analyses

Whether or not a particular merger will or will not be anticompetitive is clearly an economic issue. That does not mean, of course, that the evidence bearing on this issue is all amenable to empirical economic analyses or that lawyers and other non-economists do not have critical skills that are required to thoroughly evaluate and analyze a variety of types of evidence that must be assessed in the investigation of a proposed merger.

Many years ago I wrote, and then when back at the FTC 2001-2003, spoke out about the deficiencies I saw in the focus of economists on scanner data-based "simulation analyses." I believe that there is now a broader common understanding of the limitations of such approaches.[14] It is my view that typically the most useful sort of empirical analyses that can be conducted by economists are of "natural experiments." I gave a number of speeches at the FTC on this topic, published papers,[15] and continue to believe that the potential for this sort of analysis to provide useful contributions to merger enforcement is still larger than the actual utilization of such analyses.

Finally as an "old" economist, I cannot resist the temptation to which for decades "old" industrial organization economists have also succumbed. Put succinctly, the reality of competition, in all its dimensions, including price, is clearly different in what appear to be material respects from the models economists use to analyze mergers.[16] Economists since HSR have been confronted with innumerable very rich industry and factual settings.

---

[14] *See*, for example, Gregory Werden, Luke Froeb, and David Scheffman "A Daubert Discipline for Merger Simulation," *Antitrust Magazine*, Summer 2004

[15] David Scheffman and Mary Coleman, "Quantitative Analyses of Potential Competitive Effects From a Merger," forthcoming, *George Mason Law Review* (draft posted at http://www.ftc.gov/be/quantmergeranalysis.pdf).

[16] *See*, for example, my article "Making Sense of Mergers," *Antitrust Bulletin*, Vol. 38, No. 3, Fall 1993, pp. 715-740.

It is disappointing for the profession and the discipline, I believe, that we are still largely applying models that are modestly updated versions of economic models more than 100 years old.

Centuries ago, and continuing to this day, physicists have explored the reality of the universe and have made changes, sometimes dramatic changes, in fundamental theories, from the theories of the motions of celestial bodies to the theories of special and general relativity, and far beyond, in order to bring theory into accord with observation. As economists working in merger enforcement, we have been exposed to the scientific equivalent of a lot of information about the movement of celestial bodies – information that is clearly materially different from what is assumed in our basic economic models of competition.[17] However, unlike the physicists of centuries ago (and today), economists have not developed new theories that better fit the observed facts and that could be shown to better "predict" market and firm-specific outcomes. There are Nobel prizes waiting …

[17] As just one example, most economic models of competition, and particularly, market power assume, in an important way, "one price." This assumption is important, for example it is the basis in simple economic models of the potential relationship between market share and market power. *See*, for example, see the W. Landes and R. Posner, "Market Power in Antitrust Cases," 94 *Harvard Law Review* (1981). However, in at least most industrial markets, we see price variations that make it clear that the competitive process results in significant differences in prices across customers and that prices often do not move together closely over time. Thus, reality is often not consistent with "one price," making the relationship between market share and market power potentially much more complex. *See*, for example, Charles Holt and David Scheffman, "Facilitating Practices: The Effects of Advance Notice and Best Price Policies" (with C. Holt), *Rand Journal of Economics*, Vol. 18, No. 2, Summer 1987, 187-197.