AMERICAN BAR ASSOCIATION

Section of Antitrust Law
321 N. Clark Street
Chicago, Illinois 60610-4714
(312) 988-5550
FAX: (312) 988-5637
E-mail: antitrust@abanet.org
http://www.abanet.org/antitrust

November 10, 2005

Via Express Mail and E-mail

Antitrust Modernization Commission
Attention: Public Comments
1120 G Street, N.W.
Suite 810
Washington, DC 20005

Re: Comments Regarding the Role of Efficiencies in Merger Enforcement

Ladies and Gentlemen:

On behalf of the Section of Antitrust Law of the American Bar Association, I am pleased to submit the enclosed comments to the Antitrust Modernization Commission in response its request for comments relating to the treatment of efficiencies in merger enforcement by the Federal Trade Commission and Department of Justice selected for study by the Commission.

Please note that these views are being presented only on behalf of the Section of Antitrust Law and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

If you have any questions after reviewing this report, we would be happy to provide further comments.

Sincerely,

Donald C. Klawiter

Donald C. Klawiter
Chair, Section of Antitrust Law

Comments of the Section of Antitrust Law
of the American Bar Association
in Response to the
Antitrust Modernization Commission's
Request for Public Comment
Regarding the Appropriate Role of Efficiencies in Merger Enforcement

The Section of Antitrust Law ("Antitrust Section") of the American Bar Association ("ABA") is pleased to submit these comments to the Antitrust Modernization Commission (the "Commission") in response to its request for public comment dated May 19, 2005 regarding specific questions relating to the treatment of efficiencies in merger enforcement by the Federal Trade Commission ("FTC") and Department of Justice ("DOJ") (collectively "Federal Enforcement Agencies") selected for study by the Commission. The views expressed herein are being presented on behalf of the Antitrust Section. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the American Bar Association.

<u>Summary of Comments</u>

Are the federal enforcement agencies and courts appropriately considering efficiencies expected to be realized from transactions?

The 1997 revisions to the *Merger Guideline*s substantially clarified and improved the Federal Enforcement Agencies' treatment of efficiencies in merger review. This has resulted, in turn, in an improvement in the courts' treatment of efficiencies.

We believe, however, that the efficiencies section of the *Merger Guidelines*, which focuses primarily on marginal cost reductions, could be further improved by describing the agencies' treatment of mergers that result in (i) substantial reductions in fixed costs; and (ii) the development of new products. Currently, such efficiencies are relegated to a brief footnote that suggests that the Agencies, in their prosecutorial discretion, may consider efficiencies other than marginal cost reductions. This footnote does not describe either the types of non-marginal cost reductions that will be considered, or the conditions under which such non-marginal cost reductions will influence the Agencies' decision to prosecute. We believe that this is a topic that is of considerable significance but also one that has not received adequate attention in merger analysis. Finally, a clarification of the agencies' approach to the treatment of the pass-on of cost savings would be welcomed

Thus, we believe that the *Merger Guidelines* should be amended first, to expressly set forth the conditions under which reductions in fixed costs should be considered in merger analysis. Second, the *Merger Guidelines* should be amended to expressly set forth the conditions under which product improvements, including the introduction of new products, should be considered in merger analysis.

Comments

The Appropriate Welfare Standard

In analyzing the appropriate role of efficiencies, it is important to first determine whether the appropriate welfare standard to use in assessing efficiencies is a consumer welfare standard, a total welfare standard, or some alternative standard.

Having considered this question carefully, we believe that because case law and agency practice during the administrations of both parties are firmly based on the consumer welfare standard, it is unlikely that a total welfare standard will be adopted and we do not advocate such a change.

Suggested Revisions to *Merger Guidelines*

However, there are important ways in which efficiency arguments should be given greater credit, or be more clearly implemented. We believe that the most effective way to address these issues would be to advocate appropriate amendments to the efficiencies section of the Federal Enforcement Agencies' *Merger Guidelines.*

The 1997 revisions to the *Merger Guidelines* have substantially improved the Agencies' treatment of efficiencies, making it clear that efficiencies will be considered in most cases. The Efficiencies section of the *Merger Guidelines* appropriately focuses on reductions in marginal costs, recognizing correctly that reductions in marginal costs create incentives for the merging parties to reduce the price of the products that they offer for sale.

The Efficiencies section of the *Merger Guidelines* has also influenced the courts' treatment of efficiencies. Prior to the publication of the Efficiencies section of the *Merger Guidelines*, many courts refused to consider efficiencies in their merger analysis. See United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 371 (1963) (merger that may substantially lessen competition "is not saved because on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial."); see also FTC v. Procter & Gamble Co., 386 U.S. 568, 580 (1967) ("[P]ossible economies cannot be used as a defense to illegality.").

In contrast, some lower courts did credit efficiencies. For example, in FTC v. Butterworth Health Corp. 946 F. Supp. 1285 (D. Mich. 1996), the court stated that the merger of two hospitals would result in "significant efficiencies, in the form of capital expenditure avoidance and operating efficiencies**,** totalling in excess of $ 100 million." Id. at 1301.

The publication of the Efficiencies section of the *Merger Guidelines* has caused courts to expressly consider the parties' claimed efficiencies. See FTC v. University Health, Inc., 938 F.2d 1206, 1222 (11th Cir. 1991) ("[A] defendant may rebut the government's prima facie case with evidence showing that the intended merger would create significant efficiencies in the relevant market"); FTC v. Tenet Health, 186 F.3d 1045, 1054 (8th Cir. 1999) ("[A]lthough Tenet's efficiencies defense may have been properly rejected by the district court, the court should nonetheless have considered evidence of enhanced efficiency in the context of the competitive effects of the merger."). See also FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109, 153 (D.D.C. 2004) ("Efficiencies resulting from the transactions, then, provide some limited additional evidence to rebut the claim of port-merger anticompetitive effects.").

Most recent decisions that have recognized the efficiencies defense have generally found that the claimed efficiencies were either overstated, see, e.g., FTC v. Staples, Inc., 970 F. Supp. 1066, 1089 (D.D.C. 1997) (noting that the claimed efficiencies exceeded by 500% the cost savings estimate presented to the companies' boards of directors in seeking approval for the merger), or were not merger specific, See, e.g., FTC v. H.J. Heinz Co., 246 F.3d 709, 722 (D.C. Cir. 2001) ("[T]he district court never explained why Heinz could not achieve the kind of efficiencies urged without the merger"); F.T.C. v. Cardinal Health, 12 F. Supp. 2d 34 (D.D.C. 1998). See also United States v. Oracle Corp., 331 F. Supp. 2d 1098, 1175 (N.D. Cal. 2004) ("[The] claimed efficiencies are much too vahue and unreliable to rebut a showing of anticompetitive effects.").

In addition, in most cases the claimed efficiencies, even if credited by the court, do not affect the outcome of the decision because the merger was otherwise found to be lawful. See, e.g., United States v. Long Island Jewish Med. Ctr., 983 F. Supp. 121, 147 (E.D.N.Y. 1997).

The fact that the courts conclude that the claimed efficiencies do not outweigh the harm to consumer welfare is not surprising given that the Agency is only likely to bring a case to court where the harm to consumer welfare is quite significant. This is especially true in recent years where the agencies have tended to investigate seriously only mergers in very highly concentrated markets (i.e., post-merger HHIs well above 1800) or in less concentrated markets where the merging firms are clearly each other's closest competitors with only a distant fringe of other rivals.

Notwithstanding recent improvements in the treatment of efficiencies, we believe that the Efficiencies section of the *Merger Guidelines* could be further improved in three ways: first, by making clear that merging parties will always pass-on reductions in marginal cost, although the amount of the pass-on will depend upon a number of factors; second, by setting forth the conditions under which the Agencies will credit reductions in fixed costs; and third, by setting forth the conditions under which the Agencies will credit the ability of the merging parties to introduce new or better products as a result of the merger.[1]

[1] In settling on these recommendations, we considered other areas for comment, including whether the burden for demonstrating and quantifying efficiencies ought to be lessened or shifted in part (e.g., merger-specificity) to the Agencies. However, because data on cost savings is usually in the hands of the merging firms, we believe it is reasonable to impose a burden on them to reasonably substantiate the likelihood of efficiencies being achieved through the merger and to present the data necessary to calculate the expected

Pass On

The *Guidelines* are silent as to how the Agencies consider the pass-on of reductions in marginal costs.[2] This has created some confusion among practitioners as to how the Agencies will determine the amount of marginal cost reductions that will be passed-on to consumers in the form of lower prices.

This confusion is magnified by claims in the economic literature that reductions in marginal costs will be passed on even by a monopolist. See, e.g., Hausman and Leonard, Efficiencies from the Consumer Standpoint, 7 Geo. Mason L. Rev. 707 (1999) (economic theory predicts that even a monopolist will pass on cost savings obtained as a result of a merger).

In practice, calculating the amount of the pass-on is very complex and depends upon a number of factors, such as whether the theory of competitive harm is unilateral or coordinated effects, and whether competition is Bertrand or Cournot. See Pass-Through Rates and Price Effects of Mergers (Froeb, Tschantz and Werden) (2002) and Merger Control and Enterprise Competitiveness – Empirical Analysis and Policy Recommendations (Stennek and Frank Verboven) (2001).

Given the complexity of calculating pass-on, we do not recommend that the *Merger Guidelines* be amended to set forth the appropriate methodology for calculating pass-on. However, we would recommend that the Agencies make clear that the fact of pass-on will be presumed but that the amount of pass-on will depend upon a number of factors relating to the underlying market conditions.

In addition, we believe that the *Merger Guidelines* be amended to clarify how efficiencies, once substantiated, should be weighed against a posited post-merger price increase. Ultimately, the plaintiff bears the burden of proving that a proposed merger violates the Clayton Act. Therefore, it seems reasonable for the plaintiff to bear the burden of demonstrating that the likely price effect will be greater than the substantiated efficiencies. We recognize, however, that the tools necessary to calculate the price effect may not always be as precise as the tools used to calculate marginal cost reductions. In such cases, the plaintiff should be permitted to meet its burden of demonstrating an

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magnitude of efficiencies to be realized. Furthermore, while we believe that it is often difficult, if not somewhat speculative, for the merging parties to assess the merger-specificity of their proposed efficiencies, we believe that the burden of addressing this issue should remain in the hands of the merging parties, particularly with respect to alternatives reasonably available to the parties and seemingly practical to follow (absent the merger) in the business situation faced by them.

[2] Clearly, the *Guidelines* seem to contemplate a pass-on requirement, for example, by referring to substantiation of "how each [asserted efficiency] would enhance the merged firm's ability and incentive to compete" and by stating that "the Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market."

increase in price net of efficiencies by relying upon non-quantitative evidence (e.g., documents and testimony)

Non-Marginal Cost Efficiencies

Currently, the only authority for the Federal Enforcement Agencies to consider non-marginal costs reductions is found in footnote 37 of the *Merger Guidelines*, which states that the "Agency also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market."

Thus, it would appear that efficiencies other than marginal costs reductions are taken into account only through the Federal Enforcement Agencies' prosecutorial discretion. However, without amendment to the *Merger Guidelines* or statements by the Agencies as to why they declined to challenge a transaction, future merging parties have little guidance as to how to anticipate the Agencies' treatment of non-marginal costs reductions. This is an issue that we believe is of considerable significance and we urge that the Commission recommend that the agencies clarify their approach to this important topic.

Reductions in Fixed Costs

Antitrust commentators recognize that there are circumstances in which fixed cost savings can provide similar short-term, direct price-related consumer benefits as marginal cost reductions. For example, where fixed cost savings directly affect the pricing decisions of the merging parties, such savings should be credited similar to marginal cost reductions.[3] In addition, fixed costs may be specifically considered in determining actual pricing, particularly under cost-based contracts or under long-term contracts in which short run fixed costs become marginal over the life of the contract. Further, long-term contracts may contain price escalation clauses tied to changes in total operating costs, including fixed costs. Bid proposals or pricing models employed in setting prices may be based, not just variable or incremental costs, but also on certain elements of fixed costs. In this regard, studies of real-world pricing practices conclude that most companies base their prices on cost models that take into account at least some elements of fixed costs.[4]

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[3] William J. Kolasky, *The Role of Economics in Merger Enforcement: Efficiencies and Market Definition under Conditions of Price Discrimination*, presented at Charles River Associates Conference, "Current Topics in Merger & Antitrust Enforcement", Washington, DC, Dec. 11, 2002: "[F]ixed cost savings matter….First, which costs are variable depends in part on how long our time horizon is. With a longer horizon, costs that might otherwise appear fixed may indeed impact marginal pricing decisions….Second, under conditions of price discrimination, prices to most customers are not set at marginal costs, but are set at a level designed to recover common costs that would not be viewed as variable, under a strict variable cost standard."

[4] See, e.g., Shim and Sudit, *How Manufacturers Price Products*, Management Accounting, Feb. 1995, finding that 36 percent of surveyed companies based prices on total cost and 34 percent based prices on total production costs, while only 12 percent based prices strictly on variable costs. This study confirmed similar findings in an earlier study (1983) by Govindarajan and Anthony

We believe that in some cases, reductions in "fixed costs" will enhance business decisions that can lead to improved consumer welfare and therefore should be considered in certain circumstances. For example, there are instances where companies, in order to avoid cross-subsidization among products, customers or business segments, will take account of fixed costs when they price their products or when they prepare the underlying financial analyses used to justify product development, business expansion or other similar investment decisions. In such instances, where fixed cost savings in a merger have the potential to lead to lower prices or will lead to reduced allocations of direct, shared or common fixed costs that are incorporated in the economic justifications underlying such investment decisions, fixed cost savings should be accorded specific credit in evaluating the benefits of the proposed merger or acquisition.

New and Improved Products

We also believe that the *Merger Guidelines* should clarify the Agencies' treatment of improvement of existing products and the introduction of new products. Specifically, there may be instances where a merger will reduce competition in one product but give the merging parties incentives to create or improve another. Such efficiencies may be quite significant where the new product, in effect, replaces the old product. Thus, the Agencies may be forced to balance the welfare of those users who are able to switch to the new product against the welfare of legacy users of the old.[5] By providing guidance as to how these sometimes conflicting outcomes in a merger will be analyzed by the Agencies, the merging parties may be better able to explain and quantify the net benefit of the merger to consumers.

Efficiencies From Combining Complementary Assets

Transactions are often driven by the complementary nature of the merging firms' businesses and the ability to combine complementary and underutilized assets and specialized or unique expertise to position the merged firm to better serve customers with improved products at lower cost and sooner than could occur without the merger. Indeed, some antitrust commentators believe that the most substantial efficiencies in a merger are likely to result from combining complementary assets.[6] We believe that the Agencies

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[5] Business executives who participated in the FTC's Merger Roundtable, *Understanding Mergers: Strategy & Planning, Implementation and Outcomes*, uniformly stated that the goal of virtually all mergers is to enhance the merged firm's ability to make products that consumers will want to buy and to keep ahead of rivals by operating more efficiently. See April 21, 2004, summary of conference discussions prepared by Paul Pautler, *The FTC Merger Roundtable: Understanding Mergers: Strategy & Planning, Implementation and Outcomes*, found at http://www.ftc.gov/be/rt/mergerrndtablesummary.pdf.

[6] E.g., William J. Kolasky and Andrew J. Dick, *The Merger Guidelines and the Integration of Efficiencies into Antitrust Review of Horizontal Mergers*, 71 ANTITRUST L. J., 207 (2003); also, William J. Kolasky, *The Role of Economics in Merger Enforcement: Efficiencies and Market Definition under Conditions of*

should accord significant credit to transactions where such benefits can be reasonably demonstrated and quantified by the merging parties.[7]

Importantly, efficiencies created by combining complementary assets often promote dynamic efficiencies in the market(s) of concern, by stimulating competitive responses in innovation, product quality and product diversity by others in the market.[8] Indeed, in light of the importance innovation plays in our economy, the Agencies should provide guidance on the experience they have gained in assessing innovation and other non-price benefit claims in their overall assessment of efficiencies that may be generated by a transaction. Thus, we recommend that the Agencies include specific language in the *Guidelines* as to how and to what extent it will credit dynamic efficiencies in its assessment of merger efficiencies and its analysis of likely competitive effects of the merger.

Conclusion

In sum, the Agencies should develop and make known standards under which efficiencies that reduce fixed costs, lead to the introduction of new or improved products, or are likely to create dynamic efficiencies will be considered in merger analysis. Express guidance will improve the Agencies' stated goal of transparency and will provide the business community with important guidance in predicting the Agencies' treatment of future transactions.

Price Discrimination, presented at Charles River Associates Conference on Current Topics in Merger & antitrust Enforcement, Washington, DC, December 11, 2002.

[7] In addition, by combining complementary assets and specialized expertise, the cost and risk of investment may be reduced, which can lead to incremental investment being undertaken by the merged firm that offers the potential for increased output or lower marginal cost. The importance of a merger allowing for lower-cost investment and creating incremental investment opportunities, we believe should be specifically referenced in the *Guidelines* as a potentially important efficiency benefit.

[8] Commentators have noted that dynamic efficiencies will, over time, stimulate competitive innovation and intensify competition, essentially multiplying the beneficial effect of efficiencies realized in a merger. Gary L. Roberts and Steven C. Salop, *Efficiencies in Dynamic Merger Analysis*, 19 WORLD COMPETITION L.. & ECON. REV. 5 (1996).