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BY:

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Mr. Andrew J. Heimert, Executive Director
Antitrust Modernization Commission
1120 G Street NW, Suite 810
Washington, DC 20005

Dear Mr. Heimert:

Thank you for the opportunity to comment on Professor Kaplan's characterization of my research with David Ravenscraft at the Economists' Roundtable January 19. It may seem presumptuous of me to submit a comment in writing when I declined your invitation to appear in person. As you know, I had a conflicting class the day of the hearing. Some academicians readily waive teaching commitments; I do not. In the eight courses I have taught since retiring from Harvard in 2000, I have missed only one class session -- to undergo surgery for a cancer that was on the verge of metastasizing. During my eleven prior years at the Kennedy School, I can recall cancelling only one class session.

Had I known that the roundtable would survey merger efficiency studies, I might have submitted the enclosed paper, "The Merger Puzzle," presented in 2001 at a conference in Germany. But my impression was that the main focus would be the relationships between concentration and profitability, on which I have never undertaken original research (i.e., abstracting from textbook summaries).

Professor Kaplan characterized my findings with Ravenscraft that mergers were on average efficiency-reducing as an isolated case. Had he cast his survey wider, among other things covering the European literature, he would have found numerous other studies with similar findings. His explanation (p. 73 of the transcript) as to why our findings differed from those of others was as follows:

> Now why did Ravenscraft and Scherer find a particular result that is different from some of the others? They found a decline in accounting performance. One reason may have been

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that they studied conglomerate mergers. The other reason had to do with depreciation. If you added back depreciation, you actually got no change. But when you didn't add depreciation, you saw a decline. And depreciation often goes up after an acquisition because of purchase accounting. I would have to go back and find that out for sure, but it may be that their results are not so different from everyone else's.

On a priori grounds, I would tend to agree with Professor Kaplan's "conglomerate" hypothesis. Our study focused on the after-effects of a giant conglomerate merger wave. Conglomerates were the rage in the 1960s and early 1970s because stringent antitrust enforcement precluded most sizeable horizontal and vertical mergers. My natural instinct would be to expect more positive efficiency effects from horizontal mergers. Surprisingly, the European merger studies, covering a period before the European authorities began an active merger enforcement program, show frequent efficiency losses from mergers that must have been preponderantly horizontal. They are summarized in various editions of my Industrial Organization textbook. See also the newer studies summarized on p. 5 of my "Merger Puzzle" paper.

On depreciation, Ravenscraft and I were acutely conscious of the accounting effects to which Professor Kaplan alludes. With the largest and most detailed accounting data set (from the FTC's Line of Business program) ever used in a merger effects study, we controlled for numerous accounting variants. Our main conclusion on Professor Kaplan's point is as follows (from pp. 93-94 of Ravenscraft and Scherer, Mergers, Sell-offs, and Economic Efficiency (1987):

> For all years and regression specifications, the PURCH coefficients are consistently negative and significant. Given the table 3-1 evidence that the pre-merger profits of companies acquired under purchase accounting were insignificantly different from those of their manufacturing peers, this too implies a post-merger decline. One possible reason is the payment of premiums over the acquired entity's book value, raising post-merger asset values and depreciation charges. Both numerator and denominator of 1977 assets-deflated regression 4-2(4) are affected by the phenomenon, but only the numerator of the operating income/sales regression 4-2(8) is affected. With the latter, the PURCH effect remains significantly negative, though smaller because operating income is a much smaller fraction of sales than assets. If higher depreciation charges were an important reason for the reduced profitability of purchase accounting acquisitions, that effect should vanish when the dependent variable is measured in terms of cash flow (operating income plus depreciation). In fact, as cash-flow regressions 4-2(9) and 4-2(10) reveal, the negative PURCH effect is slightly greater in relation to sales, not smaller, with a cash flow

definition....

Quite generally, for those to whom skepticism toward our powerful results has been advised, I can only suggest, "Read our book." I continue to believe that the analysis, based upon data of extraordinary quality and with many more analyses than the one discussed in the previous paragraph, is bullet-proof.

None of this is to say that mergers seldom yield efficiencies. I am certain they do. I have described some important examples in my "Merger Puzzle" paper. I should not be surprised that as a result of the conglomerate merger wave of the 1960s, recognized by almost everyone to have been a fiasco, merger-makers have become more sophisticated in choosing targets and avoiding acquisitions for which they lack managerial skills. But we also know that there have been many failures since then. What we do not know with confidence is where the average tendency lies. For reasons spelled out in my "Merger Puzzle" paper, the "event study" methodology emphasized by Professor Kaplan yields seriously misleading and deficient inferences. As I note there, the Anrade et al. study on which he places some emphasis also has significant problems.

Recognizing the range of possibilities, I have long favored introducing an efficiencies defense into antitrust screening. In one 1976 case involving anti-friction bearing producers, the FTC Bureau of Economics under my direction took the position, accepted by the Commission, that the parties be invited to submit an efficiencies defense. (I was told later that they failed.) When the Department of Justice called for comments on its 1982 Merger Guidelines, I strongly recommended incorporating an efficiencies defense, which was done in 1984. I was expert witness in one of the first litigated efficiencies defenses, summarized on pp. 15-16 of my "Merger Puzzle" paper.

Evaluating the evidence presented in an efficiencies defense is difficult. One needs to know a lot about the industry to separate sense from nonsense. The future is inherently uncertain. Errors will be made; see e.g. p. 8 of my book, Competition Policy, Domestic and International, on the Jones & Laughlin - Youngstown steel merger. Given the tenuous balance from statistical studies between efficiency-increasing and efficiency-reducing instances, it would be prudent to err on the side of skepticism in closely contested merger enforcement cases.

Sincerely yours,

F. M. Scherer

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