Before the Antitrust Modernization Commission
Hearing on Efficiencies in Merger Enforcement

Testimony of Jonathan B. Baker[1]
November 17, 2005

Thank you for inviting me to testify about the treatment of efficiencies in merger enforcement. I will limit my testimony to horizontal mergers, because that is where the enforcement agencies and courts today undertake the closest scrutiny of proposed acquisitions.[2] My overall conclusion is that there is no serious problem involving efficiencies in merger analysis calling for intervention by the Antitrust Modernization Commission, and that in particular no recommendation for legislative action is called for.

<u>Summary of Testimony</u>

1. Courts and enforcement agencies should consider efficiency claims in reviewing horizontal mergers.
2. The federal enforcement agencies consider efficiencies routinely.
3. The federal courts are grappling with how to consider efficiencies, and should be given the opportunity to address this issue fully.

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[1] Professor of Law, Washington College of Law, American University. The views I express are not necessarily those of American University; CRA International (for which I am a Senior Consultant); or the Section of Antitrust Law, American Bar Association (which I serve as a member of its Council and its Task Force on Antitrust Modernization, and in other positions). I am grateful to Steve Salop and Andy Gavil for their comments on drafts of this testimony.

[2] I also limit my testimony to prospective mergers, and do not address the different issues raised by the analysis of efficiencies in consummated merger cases.

4. Efficiency claims should be evaluated using a consumer welfare standard, even if the ultimate goal is to maximize aggregate welfare.

5. The federal courts should be given the opportunity to address fully the allocation of the burdens of production and persuasion with respect to efficiencies.

Discussion

1. Courts and enforcement agencies should consider efficiency claims in reviewing horizontal mergers.

At one time courts questioned whether even to consider efficiency claims in reviewing horizontal mergers.[3] This is no longer the case,[4] and for good policy reasons.[5] When firms develop new business strategies, with purely procompetitive motives like reducing costs,

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[3] Fed. Trade Comm'n v. Procter & Gamble Co., 386 U.S. 568, 579 (1967); United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 371 (1963). *See generally*, William J. Kolasky and Andrew R. Dick, *The Merger Guidelines and the Integration of Efficiencies into Antitrust Review of Horizontal Mergers*, 71 ANTITRUST L.J. 207 (2003).

[4] It would be surprising if courts refused to consider efficiencies under the Clayton Act, given the importance of efficiencies in Sherman Act cases. In the wake of *Broadcast Music Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1 (1979), courts have come to accept that they can and must analyze efficiencies in evaluating horizontal agreements under Sherman Act §1, even if those agreements concern price or divide markets, as would a horizontal merger.

[5] For recent surveys of the economic literature on mergers and merger efficiencies, which address many of the policy issues discussed in this section of my testimony, see Lars-Hendrik Röller, Johan Stennek & Frank Verboven, Efficiency Gains from Mergers (2005) (unpublished manuscript), *available at* http://europa.eu.int/comm/competition/speeches/text/sp2005_013_en.pdf; Paul Pautler, *Evidence on Mergers and Acquisitions,* 48 ANTITRUST BULL. 119 (2003); and Gregor Andrade, Mark Mitchell & Eric Stafford, *New Evidence and Perspectives on Mergers,* 15 J. ECON. PERSPECTIVES 103 (2001).

improving quality, or developing new products, they often need to reconfigure their assets. In some cases, the specialized assets they seek are only in the hands of rivals, and it is less expensive and faster for them to acquire those assets through acquisition than to create them. If the assets are not being employed effectively by the management of the firm that currently owns them, they may be available cheaply. Any particular merger could in consequence be the least expensive way for firms to implement business strategies reasonably calculated to benefit buyers as well as the merged firm.

But there are also good policy reasons to scrutinize efficiency claims carefully. One is that a substantial fraction of mergers do not appear to generate cost savings or other efficiencies. Also, while efficiencies from horizontal merger may often lead to lower prices, they do not necessarily do so. With respect to unilateral effects, even substantial reductions in marginal cost may not be sufficient to generate price declines if firms behave as is supposed by some common oligopoly models.[6] With respect to coordinated effects, if industry coordination is imperfect and incomplete, a transaction conferring efficiencies on the merging firms could under some circumstances lead to *higher* prices by increasing the threatened punishment facing a non-merging firm that constrains industry prices (a maverick).[7] These possibilities are best addressed by conducting a careful competitive analysis in each case, in which efficiencies would play a

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[6] Joseph Farrell & Carl Shapiro, *Horizontal Mergers: An Equilibrium Analysis*, 80 AM. ECON. REV. 107 (1990); Gregory J. Werden, *A Robust Test for Consumer Welfare Enhancing Mergers Among Sellers of Differentiated Products*, 44 J. INDUS. ECON. 409 (1996).

[7] Jonathan B. Baker, *Mavericks, Mergers, and Exclusion: Proving Coordinated Competitive Effects Under the Antitrust Laws*, 77 N.Y.U. L. REV. 135, 186-87 (2002). Efficiencies can also reduce the effectiveness of coordination, and lead to lower prices, as by enhancing the incentive of the maverick to keep industry prices low or by creating a new maverick.

role, not by refusing to consider efficiency claims.

2. The federal enforcement agencies consider efficiencies routinely.

Efficiencies are routinely considered in horizontal merger analysis at the federal enforcement agencies, and have been for a long time. I recall efficiencies mattering in the analysis of horizontal mergers at the F.T.C. when I worked there during the late 1990s and I recall efficiencies mattering at the Antitrust Division when I worked there during the early 1990s.[8] I imagine any former agency official would say the same thing. The federal antitrust agencies codified their experience in 1997 by issuing revisions to the Horizontal Merger Guidelines that set forth a detailed and reasonable approach to the analysis of efficiencies.[9]

3. The federal courts are grappling with how to consider efficiencies, and should be given the opportunity to address this issue fully.

The federal courts today are willing to evaluate efficiency claims in analyzing horizontal mergers,[10] although they have not yet relied on evidence of efficiencies to reject a merger

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[8] I served as Director of the Bureau of Economics at the F.T.C. from 1995 to 1998, and as Special Assistant to the Deputy Assistant Attorney General for Economics 1991 to 1993. In each of those positions I participated in the review of most if not all of the proposed mergers addressed by senior agency decision-makers.

[9] U.S. Dep't of Justice and Fed. Trade Comm'n, Horizontal Merger Guidelines §4 (1992, revised 1997). Although I participated in drafting these agency guidelines, my interpretation of them is not necessarily that of either federal enforcement agency.

[10] *E.g.*, Fed. Trade Comm'n v. Arch Coal, Inc., 329 F. Supp. 2d 109 (D.D.C. 2004); United States v. Oracle Corp., 331 F. Supp. 2d 1098 (N.D. Cal. 2004); Fed. Trade Comm'n v. H.J. Heinz, Co., 116 F. Supp. 2d 190 (D.D.C. 2000), *rev'd*, 246 F.3d 708 (D.C. Cir. 2001); Fed. Trade Comm'n v. Staples, 970 F. Supp. 1066 (D.D.C. 1997); United States v. Mercy Health

challenge unless the challenge was also rejected on other grounds.[11] Although the courts have to date been more generous to defenses based on ease of entry than to defenses based on efficiencies,[12] it is difficult to read much into that record given how infrequently merger efficiencies have been reviewed. I am unaware of any instance in which a modern court evaluating a horizontal merger has declined to consider significant and unconstested evidence of efficiencies. As the courts are grappling seriously with how to consider efficiencies, there is no pressing need for legislative intervention as that judicial process proceeds.

To explore how courts approach merger efficiencies further, it is useful to examine the office supply superstores merger case, *Federal Trade Commission v. Staples*, 970 F. Supp. 1066 (D.D.C. 1997), and the baby food merger case, *Federal Trade Commission v. H.J. Heinz, Co*., 116 F.Supp. 2d 190 (D.D.C. 2000), *rev'd*, 246 F.3d 708 (D.C. Cir. 2001).[13] Although I do not agree with the ultimate resolution of one of these court challenges, I highlight these cases to show that judges are fully engaged in the evaluation of efficiency claims and that they are

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Services, 902 F. Supp. 968 (N.D. Iowa 1995), *vacated as moot*, 107 F.3d 632 (8th Cir. 1997).

[11] *E.g.*, Advocacy Org. for Patients & Providers v. Mercy Health Servs., 987 F. Supp. 967 (E.D. Mich. 1997); Fed. Trade Comm'n v. Butterworth Health Corp., 946 F. Supp. 1285 (W.D. Mich. 1996), *aff'd*, 121 F.3d 708 (6th Cir. 1997) (unpublished opinion); United States v. Long Island Jewish Med. Ctr., 983 F. Supp. 121 (E.D. N.Y. 1997).

[12] Defendants have successfully overcome government challenges to proposed horizontal mergers with proof that entry would solve the predicted competitive problem, even when post-merger concentration and its increase were substantial.

[13] I know these cases well because I was involved in the *Staples* litigation while working at the F.T.C. and I testified in *Heinz* as the economic expert for the merging firms. I discuss them in more detail in Jonathan B. Baker, *Econometric Analysis in* FTC v. Staples, 18 J. PUB. POL'Y & MARKETING 11 (1999) and Jonathan B. Baker, *Efficiencies and High Concentration: Heinz Proposes to Acquire Beech-Nut (2001)*, *in* John E. Kwoka, Jr. and Lawrence J. White, eds., THE ANTITRUST REVOLUTION 150 (4th ed. 2004).

developing a reasonable analytical framework to address them.

In *Staples*, the merging firms offered an attractive efficiency argument. They explained that success in their industry came from selling at volume, leveraging increases in a firm's total sales into discounts from suppliers, and passing through those discounts to consumers in the form of lower prices. Doing so leads to still more sales, greater discounts from suppliers, even lower prices, and so on in a continuing, virtuous circle. The merger would benefit consumers, under the firms' view, by doubling the acquiring firm's sales volume in one stroke, accelerating this process.

The district court was sympathetic to this argument, highlighting "the undeniable benefits" that the merging firms brought to consumers. But after careful review of the evidence, it concluded that the proposed merger would harm competition, mainly because it saw the transaction as a merger to monopoly or duopoly in many markets,[14] but also because the merging firms' efficiency claims were "unreliable" and "unverified." The court based its conclusion about efficiencies on a number of factors, including: the testimony of the F.T.C.'s accounting expert, who reviewed the parties' efficiency claims line-by-line; the absence of documentation for many of those line items; a determination that the baseline, against which cost savings should be measured, should account for the substantial cost savings that were likely were the firms not

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[14] The merger was found likely to harm competition primarily based on evidence that prices were higher in metropolitan areas where fewer superstore chains competed, and that prices declined in those areas when an additional superstore chain entered. This evidence demonstrated that the loss of head-to-head competition between superstores would lead to higher prices. The court relied on this evidence to define a product market limited to consumable office supplies sold through office superstores and geographic markets limited to metropolitan areas. The proposed transaction was a merger to monopoly in many markets and a merger to duopoly in many others.

to merge;[15] and on the evidence that the efficiency claims presented at trial were up to five times greater than the estimates previously developed and relied upon by the merging firms in explaining the transaction to their boards of directors and investors. The court also found that only about fifteen percent of the cost savings would likely be passed through to consumers, far less than the two-thirds figure projected by the merging firms.

In *Heinz*, the merging firms explained and the district court found that the merger would likely benefit both competition and buyers by virtue of its efficiencies.[16] As the facts appeared to the district court and the merging firms,[17] the transaction would have combined the two smaller firms in a three-firm industry, where the leading firm accounted for more than two-thirds of sales nationwide and a high share in every metropolitan area. Before the merger, neither merging firm could expand output cheaply. One of the merger partners had a strong brand, but it produced its products in an old, high-cost production facility. The other merger partner had a modern low-cost plant, operating with substantial excess capacity, but its brand did not command buyer loyalty, and its products sold on average for 15% less than those of the other two firms. Also, both sellers had difficulty expanding output because each had limited distribution: the typical retailer carried the leading firm's products and at most one other firm's brand, so the products of

[15] The government had pointed out that the merging firms were growing rapidly and had plans to continue to grow. In consequence, they would each likely have achieved their post-merger size in a few years absent the merger. If so, only the timing advantage would be merger-specific.

[16] The district court also rejected the government challenge on the alternative ground that the loss of competition would be unlikely to harm competition (even absent the efficiencies).

[17] I am sketching the facts as I understood them when I testified as the economic expert for the merging firms. This description is not consistent with the decision of the appeals court, which found clear error in many of the factual determinations made by the district court.

each merging firm were carried in less than half the possible retail outlets. As a result, each merging firm faced a substantial cost disadvantage relative to the leading firm in distribution and promotion, and in the introduction of new products.

The efficiencies from merger would remove these impediments to output expansion, allowing the merged firm to produce and sell more inexpensively and giving it a powerful incentive to compete aggressively.[18] The merged firm would sell the strong brand, and produce that product in the low cost plant. As a result, the variable costs of manufacturing the strong brand would decline by 43%, generating a 15% reduction in the marginal cost of producing and distributing the strong brand. The merged firm would be expected to pass the full amount of those marginal cost savings through to consumers,[19] by selling the strong brand at the weak brand's price.[20] The merged firm would also introduce into the U.S. two major product line innovations that it had not considered profitable investments when it had access to only half the possible retail outlets.

I would expect that any court convinced of facts like these would do what the district

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[18] Notwithstanding the substantial increase in concentration in most markets, moreover, there was little danger that the loss of competition between the merging firms would provide an incentive for higher prices (even if there were no efficiencies from merger), whether through coordinated or unilateral effects. Because the merging firms had difficulty expanding output cheaply, neither constrained the leading firm's pricing. Wholesale competition (for shelf space) between the merging firms would be lost with merger, but that loss was unlikely to harm buyers as it was unlikely to affect the retail price for the product.

[19] Estimates of the demand function suggested that full pass-through was likely, consistent with the acquiring firm's business plan.

[20] Accordingly, previous customers of the leading firm or of the merging firm with strong brand would be able to buy a strong brand for 15% less; and previous customers of the merging firm with the weak brand would be able to buy a superior brand at the price at which they previously purchased the weak brand.

court in *Heinz* did: decline to enjoin the merger. The district court directly confronted the question of whether efficiencies can justify a merger that raises a serious concern derived from its effect on market concentration, and answered that question in the affirmative. The appeals court in *Heinz* did not reach this issue because the panel did not see the facts the same way after what one commentator termed "an extraordinary amount of appellate factfinding."[21] While the D.C. Circuit was plainly cautious about accepting an efficiency justification for a merger to duopoly in a preliminary injunction proceeding,[22] it explicitly left open the possibility that such a justification could prevail later, were the case to proceed to a full trial on the merits.[23] Given the facts that the appellate panel found were supported by the evidence, the circuit court's application of the law to the evaluation of efficiencies was unremarkable.

As these examples illustrate, courts no longer decline to consider efficiencies in evaluating challenges to horizontal mergers. Moreover, the parties to such cases routinely present sophisticated economic evidence as to efficiencies, and the courts in most instances analyze that evidence carefully. With the overall number of those cases small, the courts are only beginning to develop comprehensive standards for judging efficiency claims. With no reason to think the courts are moving in an inappropriate direction, and with detailed and reasonable

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[21] William J. Kolasky, *Lessons from Baby Food: The Role of Efficiencies in Merger Review*, 16 ANTITRUST 82 (2001).

[22] Most of the factual findings that the appellate panel cited as incorrectly accepted by the district court involved aspects of an efficiencies justification. A similar caution is expressed in the efficiencies section of the Horizontal Merger Guidelines, which state that efficiencies "almost never justify a merger to monopoly or near-monopoly." U.S. Dep't of Justice and Fed. Trade Comm'n, Horizontal Merger Guidelines §4 (1992, revised 1997).

[23] After the appeals court directed the district court to enter a preliminary injunction, the merger was abandoned by the parties and the administrative complaint was dismissed.

agency guidance on efficiencies available for judges to draw on, the courts should be given the opportunity to consider the role of efficiencies in merger analysis fully. Accordingly, I would encourage the Antitrust Modernization Commission not to make a legislative recommendation on this topic.

4. Efficiency claims should be evaluated using a consumer welfare standard, even if the ultimate goal is to maximize aggregate welfare.

A difficult question about the welfare standard that preoccupies commentators was not addressed in either *Staples* or *Heinz*. These cases did not present a conflict between the two welfare standards most commonly suggested: consumer welfare (by which I mean an exclusive concern with consumers' surplus) and aggregate welfare.[24] The merger proposed in *Staples* would have harmed consumers and reduced aggregate welfare. The merger proposed in *Heinz*, as understood by the district court, would have made consumers better off and enhanced aggregate welfare.

The welfare standard question may arise in a number of ways. One is the question of whether fixed cost savings, which the firms would not be expected to pass through to their

[24] Throughout this testimony, I use the term consumer welfare to refer to a standard concerned solely with consumers' surplus, and the term aggregate welfare to refer to a standard concerned with aggregate (total) surplus (which includes both consumers' and producers' surplus). I decline to adopt the confusing terminology of some aggregate welfare partisans, including Robert Bork, who use the term consumer welfare to refer to aggregate surplus. I also follow the convention of the commentary by discussing welfare issues using a partial equilibrium framework.

buyers, should count in favor of a transaction likely to raise price.[25] If the merger is thought likely to result in higher prices or other consumer harm (such as reduced quality or lessened likelihood of new product introduction) and if, in addition, the ensuing allocative efficiency loss is less than the production efficiency benefit that arises from fixed cost savings, then the antitrust evaluation of the agreement turns on the welfare standard. Such an agreement would be considered harmful under a consumer welfare standard, because prices would rise, but not under an aggregate welfare standard, as aggregate surplus increases (the production cost savings exceed the allocative efficiency loss).

The welfare standard could also matter when the efficiencies from merger involve a reduction in marginal cost that is not passed on to consumers sufficiently to prevent prices from rising. In particular, suppose that a merger is thought likely to raise price, while also generating a substantial reduction in marginal cost that would not likely be passed through to consumers. Such an agreement would be considered harmful under a consumer welfare standard, because price would rise. But if the production cost savings exceeded the allocative efficiency loss, the merger would not be considered harmful under an aggregate welfare standard, as aggregate surplus increases.

In addition, the welfare standard could matter if the horizontal merger has exclusionary effects, raising the variable costs of non-merging rivals. If the production cost savings to the merging firms are small, the merger leads only to a small decline in the market price, and if

[25] I do not address the common problem of determining which costs are fixed and which are variable, except to note that which costs are variable depends on what decision the firm is making (for example, whether to expand output by one unit, add a new facility or product line, or how quickly to expand output). I also do not address the problem of measuring efficiencies net of wasteful rent-seeking conduct.

industry demand is relatively inelastic, the aggregate welfare effect of the transaction could readily be dominated by the higher production and distribution costs of the non-merging firms,[26] in which case aggregate welfare would decline. This merger would be seen as harmful to competition under an aggregate welfare standard, even though it would be procompetitive under a consumer welfare standard.[27]

In my experience, agency investigations rarely turn on the welfare standard, in part because of the difficulty and uncertainty involved in quantifying the magnitude of the welfare consequences of mergers. Most commonly, the agency would reach the same conclusion as to whether competition has been harmed by the conduct under review regardless of the welfare standard.[28] When the issue does come up, however, enforcers and courts should generally prefer consumer welfare.[29]

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[26] For example, if the transaction gave the merged firm the ability to obtain a disproportionately large share of the shelf space at retailers for its products (including those of the acquired firm), the result could readily be to raise substantially the marginal costs of distribution of the remaining sellers. Their market share need not decline, as they might simply match the small price reduction of the merged firm. Also, the remaining firms need not be forced to exit. For example, the firms might sell differentiated products, and the non-merging firms might see their price-cost margins shrink dramatically while remaining profitable.

[27] I assume that the only practical remedy would be to challenge the merger: that it would not be possible for the government or the disfavored rival (as a private plaintiff) to identify and successfully challenge post-merger exclusionary practices of the large firm that makes this outcome possible, or else that the exclusionary practices are inextricably linked to the efficiencies from merger. (Similarly, antitrust prohibits horizontal mergers creating a likelihood of coordinated effects, rather than permitting the merger and attacking post-merger tacit collusion under the Sherman Act.)

[28] *Accord*, Terry Calvani, *Rectangles & Triangles: A Response to Mr. Lande*, 58 ANTITRUST L.J. 657 (1989).

[29] Elsewhere, I explain that the antitrust laws should generally be enforced to protect consumer welfare in all contexts, not just horizontal merger analysis, in order to maximize

A consumer welfare standard is preferable even if the ultimate goal of antitrust enforcement is viewed as maximizing aggregate welfare.[30] This is because applying the consumer welfare standard will likely deter firms from proposing some anticompetitive mergers that firms would be willing to attempt under an aggregate welfare test, but will likely make little difference in the willingness of firms to propose efficiency-enhancing mergers.[31]

On the one hand, there is little danger that the application of a consumer welfare standard would discourage transactions likely to enhance aggregate welfare. One reason is that antitrust doctrines generally, and the rules regarding merger analysis in particular, have evolved since the 1960s to make it unlikely that mergers generating efficiencies will be systematically stopped or

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aggregate welfare by protecting the political consensus in favor of competition policy. Jonathan B. Baker, *Competition Policy as a Political Bargain*, 73 ANTITRUST LAW JOURNAL __ (forthcoming 2006). For a recent survey of the arguments for a consumer welfare standard, see Steven C. Salop, Question: What is the Real and Proper Antitrust Welfare Standard? Answer: The *True* Consumer Welfare Standard (November 2005) (unpublished manuscript).

[30] Commentators have also offered reasons to prefer consumer welfare over an aggregate welfare test for its own sake. One is that consumers are entitled to the surplus they would receive under competition. Robert H. Lande, *Chicago's False Foundation: Wealth Transfers (Not Just Efficiency) Should Guide Antitrust*, 58 ANTITRUST L.J. 631 (1989). Much as the institution of private property can be defended both as a right and as creating efficiency-enhancing incentives (for investment), the consumer welfare standard can be justified both as an entitlement (Lande's emphasis) and as creating efficiency-enhancing incentives (the emphasis here). This analogy is explored in Steven C. Salop, Question: What is the Real and Proper Antitrust Welfare Standard? Answer: The *True* Consumer Welfare Standard (November 2005) (unpublished manuscript). Another defense of the consumer welfare standard in commentary is the argument that Congress mandated it. Joseph Kattan, *Efficiencies and Merger Analysis*, 62 ANTITRUST L.J. 513, 528 (1994).

[31] For a discussion of the benefits and costs of antitrust rules and enforcement generally, see Jonathan B. Baker, *The Case for Antitrust Enforcement*, 17 J. ECON. PERSPECTIVES 27 (2003).

deterred.[32] One important doctrinal change reducing that likelihood is the introduction of the antitrust injury requirement.[33] Another is the erosion of antitrust's structural presumption, after which evidence on market concentration has become simply "a convenient starting point" for a "totality-of-the-circumstances" analysis of the proposed transaction.[34] A third doctrinal change is the modern rule that if entry is easy, the transaction is unlikely to harm competition regardless of the post-merger level or increase in concentration.[35] Accordingly, firms today should have a great deal of confidence that in most instances, antitrust enforcement is unlikely to prevent them from appropriating the efficiency benefits that they are able to realize through merger.

Application of a consumer welfare standard is also unlikely to discourage many mergers that strongly promote aggregate welfare (relative to the application of an aggregate welfare test) because of information asymmetries between the merging firms and the antitrust enforcement

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[32] As previously noted, however, I see the appellate decision in *Heinz* as an exception.

[33] Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477 (1977).

[34] United States v. Baker Hughes Inc., 908 F.2d 981, 984 (D.C. Cir. 1990). *Accord*, Fed. Trade Comm'n v. H.J. Heinz, Co., 246 F.3d 708 (D.C. Cir. 2001). The Federal Trade Commission allows more horizontal mergers than it challenges unless the number of significant firms would drop to four or fewer as a result of the transaction. The line is at three or fewer outside of oil, chemicals, groceries and pharmaceuticals. Fed. Trade Comm'n, HORIZONTAL MERGER INVESTIGATION DATA, FISCAL YEARS 1996-2003 (2004) (Tables 4.1 & 4.3), *available at* http://www.ftc.gov/os/2004/08/040831horizmergersdata96-03.pdf. These data are derived only from those transactions in which the agency issued a second request, so they concern the five percent of reported acquisitions in which there was *already* some reason for the agency to look closely at the deal. The implication of these statistics is that the vast majority of horizontal mergers, even in industries with market structures raising some concern under the standards of the Horizontal Merger Guideline, face little risk of challenge. (The Antitrust Division does not publish comparable statistics, but there is no reason to think enforcement tendencies are different there.)

[35] United States v. Waste Mgmt, Inc., 743 F.2d 976 (2d. Cir. 1984); United States v. Baker Hughes Inc., 908 F.2d 981 (D.C. Cir. 1990).

agencies. First, commitment to a consumer welfare standard induces firms on average to propose mergers that generate efficiencies rather than harm competition, given that firms know more about likely cost savings than do the enforcers.[36] In addition, when merging firms can easily restructure contracts to obtain efficiencies at less threat of harm to competition, but enforcers have difficulty in obtaining the information necessary to prove the availability of practical less restrictive alternatives, the social cost of adopting a consumer welfare standard rather than an aggregate welfare test lies not in discouraging procompetitive mergers altogether, but merely in the expense firms bear (if any) in reworking their proposals to confer more of the benefits on consumers.[37]

By contrast, the greater danger today is the reverse: that harmful mergers would fall through the cracks at the enforcement agencies, though not because of any lack of skill or concern on the part of enforcers. Under such circumstances, application of a consumer welfare standard, which makes it more difficult for firms to convince agencies and courts that their transaction does not harm competition relative to the aggregate welfare standard, would be

[36] David Besanko & Daniel F. Spulber, *Contested Mergers and Antitrust Policy*, 9 J. L. ECON. & ORG. 1 (1993). See also Joseph Farrell, *Negotiation and Merger Remedies: Some Problems, in* Francois Lévêque and Howard Shelanski, eds., MERGER REMEDIES IN AMERICAN AND EUROPEAN COMPETITION LAW (2004) (some enforcer hostility to efficiency claims can discourage merging firms from seeking out deals that would confer both efficiencies and market power).

[37] Steven C. Salop, Question: What is the Real and Proper Antitrust Welfare Standard? Answer: The *True* Consumer Welfare Standard (November 2005) (unpublished manuscript); Sven-Olof Fridolfsson, *A Consumer Surplus Defense in Merger Control* (Working Paper, February 2002), *available at* http://congrega.fund.uc3m.es/earie2002/papers/paper_309_20020326.pdf. If the firms cannot cheaply rework their transactions to eliminate the allocative efficiency loss, moreover, the enforcement agency may be able to craft an order or settlement that does so by using its injunctive power.

expected to deter some anticompetitive transactions that would occur if the aggregate welfare standard is employed.

Most merger enforcement takes place at the federal enforcement agencies,[38] with agency concerns resolved by settlement or abandonment of the transaction rather than through litigation. The agencies can simply miss harmful acquisitions for many reasons. One is the limits on their resources.[39] Another is the size of transaction and size of party thresholds for pre-merger notification. Many mergers are not reported mainly because the firms or assets involved are too small, and in consequence may not come to the attention of the enforcement agencies.[40] These transactions could potentially create substantial harm in small markets. A third reason the agencies may not challenge harmful mergers involves the limits of agency expertise. Justice Department and F.T.C. lawyers and economists accumulate a great deal of knowledge about some industries over time, but they cannot be expected to know about every market within those industries or to have equal familiarity with all industries. This is not a problem once an investigation begins and discovery takes place. But it could mean that potentially anticompetitive mergers are not flagged initially for review. A fourth reason that antitrust enforcement agencies might miss mergers creating competitive problems is the dependence of

[38] Although private parties and state attorneys general occasionally bring merger cases, the federal enforcement agencies are the principal locus of merger reviews and challenges.

[39] The federal agencies plainly had insufficient resources to investigate all potentially troublesome mergers during the late 1990s merger wave.

[40] The agencies do sometimes learn about non-reportable transactions, for example through the press or through complaints. But they do not automatically learn about these deals.

the agencies on customer complaints.[41] When the products of the merging firms account for a small fraction of customer expenditures, customers may not find it cost effective to learn enough about their suppliers to recognize a problem. Even if customers are concerned, moreover, they may not complain to the agencies. Customers commonly must deal with the merging firms in the future whether the merger is allowed or prohibited, often in more complex ways than simply placing orders, and they may in consequence prefer not to make that relationship more difficult by being seen to support an agency inquiry.[42]

Even if the agencies identify possible harms to aggregate welfare, moreover, they may not always seek or obtain relief, for several reasons. First, the agency may set its hurdle for challenge high in transactions that raise litigation risks for the enforcement agencies,[43] perhaps because of the novelty of the competitive effects theory, past litigation difficulties when

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[41] The likely magnitude of buyer substitution in response to higher prices is the central economic question both in market definition and in identifying unilateral competitive effects from merger when products are differentiated. Not surprisingly, the enforcement agencies pay careful attention to the views of informed, representative, and unbiased customers when evaluating likely buyer behavior. By contrast, a federal district court recently erred when it refused to consider customer views when defining markets and evaluating the unilateral effects of merger on the ground that those views were not based on an expensive new analysis that would not routinely be undertaken in the ordinary course of business. United States v. Oracle Corp., 331 F. Supp. 2d 1098 (N.D. Cal. 2004). (Another district court that recently questioned the probative value of customer evidence in merger analysis was on stronger ground, since the customer testimony in that coordinated effects case addressed likely *seller* conduct post-merger, a subject about which buyers may know little. Fed. Trade Comm'n v. Arch Coal, Inc., 329 F. Supp. 2d 109 (D.D.C. 2004).)

[42] Some customers might threaten to complain to antitrust enforcers, as a way of bargaining for better terms. But that conversation, if it were to take place, would most likely occur out of sight of the enforcement agency, as it can be difficult to walk away from a complaint once made.

[43] I am not making a normative statement here, and in particular do not mean to suggest that the agencies ought to be risk averse in bringing cases.

challenging other transactions in the same the industry, idiosyncratic problems with the evidence in the case, or the risk aversion of agency officials. Second, the merging firms may be more effective than adversely affected buyers in shaping agency views. When merging firms are better able to lobby enforcers than are consumers, a consumer welfare standard operates as a commitment device to promote aggregate welfare.[44]

In sum, from the perspective of the aggregate welfare standard, the application of a consumer welfare standard to evaluate mergers rather than the aggregate welfare test poses little risk that horizontal merger enforcement would systematically deter procompetitive transactions, while increasing the likelihood that the antitrust laws will deter transactions that would harm competition. On average, therefore, the application of a consumer welfare standard in merger analysis by the agencies and courts is more likely to promote aggregate welfare than is the use of an aggregate welfare test.[45]

The efficiencies section of the Horizontal Merger Guidelines is sympathetic to a consumer welfare standard, without being doctrinaire. The Guidelines emphasize agency concern with protecting consumers against mergers that would lead to higher prices. For the reasons indicated above, this consumer-oriented posture also promotes aggregate welfare.

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[44] Damien J. Neven and Lars-Hendrik Röller, Consumer Surplus vs. Welfare Standard in a Political Economy Model of Merger Control (Working Paper, December 2003); *see* Joseph Farrell, Negotiation and Merger Remedies: Some Problems, *in* Francois Lévêque and Howard Shelanski, eds., MERGER REMEDIES IN AMERICAN AND EUROPEAN COMPETITION LAW (2004) (some enforcer hostility to efficiency claims promotes aggregate welfare when the merging firms have greater bargaining power than the agencies).

[45] This is not an argument for ignoring efficiency claims entirely, because doing so would then deter mergers that benefit consumers. Under a consumer welfare standard, efficiencies count in favor of a merger, so long as they are sufficient to prevent consumer injury.

The emphasis of the Guidelines on consumers is qualified. The agencies note that under some circumstances, they would count cost savings "with no short-term, direct effect on prices" as a reason not to challenge the acquisition,[46] thus preserving leeway not to challenge some mergers that raise prices while simultaneously reducing costs.[47] The placement of the qualifying language in the margin sends the message that the agencies expect to use that discretion only in unusual cases, where the production cost savings are substantial while the loss to consumers appears small. This is a reasonable approach, and I would encourage the Antitrust Modernization Commission to endorse the existing agency guidance in this area.

5. The federal courts should be given the opportunity to address fully the allocation of the burdens of production and persuasion with respect to efficiencies.

The allocation of burdens of production and persuasion with respect to efficiencies can matter because of the difficulty in evaluating harms to competition from a merger that generates efficiencies.[48] For example, suppose that (1) harms to competition are assessed under a consumer welfare standard, (2) price is the only dimension of competition likely affected by a merger, (3) the competitive concern is unilateral effects, and (4) both the incentive to raise price

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[46] U.S. Department of Justice and Fed. Trade Comm'n, Horizontal Merger Guidelines §4 n.37 (1992, revised 1997).

[47] *Cf.* William J. Kolasky and Andrew R. Dick, *The Merger Guidelines and the Integration of Efficiencies into Antitrust Review of Horizontal Mergers*, 71 ANTITRUST L.J. 207, 230 (2003) (interpreting the Guidelines as adopting a hybrid consumer welfare/total welfare model).

[48] The burden of proof has two components, the burden of production (sometimes also termed the burden of going forward) and the burden of persuasion.

unilaterally absent cost savings and the reduction in marginal cost can be quantified. Under these assumptions, the determination of whether the merger is likely to harm competition comes down to measuring the rate at which marginal cost savings would be passed-through to buyers, which can be difficult to quantify.[49] The task of determining whether competition was harmed would become even more difficult if cost savings that are not passed through to buyers also count (as they would under an aggregate welfare standard), if possible harms to competition on non-price dimensions like quality or new products must be evaluated, if the competitive concern involves coordinated effects as well as unilateral effects, and if it the likely effects of the transaction are difficult to quantify.

In the modern case law,[50] the government bears the burden of persuasion when it challenges a merger, but, as with all other cases, the burden of production shifts.[51] The government satisfies its initial burden of production by introducing evidence that market concentration is high and increasing (thus establishing a prima facie case through application of

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[49] Based on my experience attempting to quantify the pass-through rate in merger in *Staples* (for the F.T.C.) and *Heinz* (for the merging firms), I would not expect it to be possible routinely for litigants to be able to make good quantitative estimates of the pass-through rate. One reason is that the pass-through rate depends on the curvature of demand (rate of change of the slope or elasticity), which will often be more difficult to estimate than the elasticity itself.

[50] I focus in this section on the allocation of burdens of proof in the courts. In theory, it would be possible to demand different standards for proof or to apply different welfare standards in evaluating mergers in the enforcement agencies than what is required in the courts. This possibility is potentially attractive because it creates an additional policy instrument. But in practice it founders on the difficulty that agencies would face in convincingly telling a court "If the facts are as you see it, we would not have brought this case but you must nevertheless find a violation."

[51] United States v. Baker Hughes Inc., 908 F.2d 981 (D.C. Cir. 1990); Fed. Trade Comm'n v. H.J. Heinz Co., 246 F.3d 708 (D.C. Cir. 2001).

antitrust's structural presumption),[52] and articulating the economic logic by which it believes competition would be harmed. This demonstration shifts a burden of production to the merging firms to explain why the inference from the change in market concentration is unlikely in fact to lead to harm to competition, for example by successfully challenging the government's market definition or showing that entry would likely be of sufficient speed and scope to deter or counteract any competitive problem.[53] If the merging firms satisfy their burden of production, the burden of production shifts back to the government, which may discredit the defendants' showing or provide additional evidence of anticompetitive effect. The burden of persuasion remains on the government at all times.

The case law has not fully worked out how to deal with burdens of production and persuasion for efficiencies consistent with this framework.[54] The cases that consider efficiencies routinely describe them as arguments by which defendant seeks to rebut the plaintiff's prima facie case based on market structure.[55] This articulation suggests that a burden of production is placed on the defendant, as is the case with defense arguments based on ease of entry. But the case law has not yet clarified whether efficiencies should be treated simply as a defense, like

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[52] I note in passing that market shares are particularly poor predictors of harm to competition when the competitive effects theory involves unilateral effects among sellers of differentiated products, calling into question whether it makes sense to insist that the government make a prima facie case based on market concentration under such circumstances.

[53] To satisfy a burden of production, a party must provide enough evidence to avoid summary judgment or judgment as a matter of law in favor of the other side.

[54] Nor have the cases clarified burden of proof issues that arise with respect to analyzing whether efficiencies are merger specific and substantiated.

[55] *E.g* Fed. Trade Comm'n v. Staples, 970 F. Supp. 1066 (D.D.C. 1997); Fed. Trade Comm'n v. H.J. Heinz Co., 246 F.3d 708 (D.C. Cir. 2001).

entry, or as an affirmative defense, which would typically also carry with it a burden of persuasion.

One reasonable way to do so would be to treat proof of efficiencies as a "defense" under most circumstances (shifting a burden of production, not persuasion), but as an "affirmative defense" (shifting both burdens) in other cases.[56] In particular, if efficiencies claims are offered to disprove plaintiff theories of coordinated or unilateral competitive effects by tending to disprove, for example, the government's claim that price would rise, they would play the role of a defense (not an affirmative defense).[57] In the rare case in which efficiencies were offered as evidence that would excuse higher prices, for example by demonstrating the magnitude of cost savings not passed through to buyers,[58] the defendants would have to satisfy both a burden of production *and* the burden of persuasion.[59] This way of structuring the allocation of burdens of production and persuasion with respect to efficiency claims would harmonize them with the way such burdens are typically allocated elsewhere in merger enforcement and, more generally, civil

[56] For discussions of the relationship between the rationale for crediting efficiencies and the allocation of burdens of proof, *see generally* Andrew I. Gavil, *Secondary Line Price Discrimination and the Fate of Morton Salt: To Save It Let It Go,* 48 EMORY L. J. 1057, 1119-20 (1999); Andrew I. Gavil, *Exclusionary Distribution Strategies by Dominant Firms: Striking a Better Balance*, 72 ANTITRUST L.J. 3, 69-74 (2004).

[57] This is the role such claims would play if harm to competition is evaluated using a consumer welfare standard. Implicitly under such an approach, the merging firms would have to meet a burden of production with respect to pass-through of cost savings to buyers.

[58] As discussed above in connection with the welfare standard, I would not allow cost savings not passed through to buyers to count in defense of a merger likely to raise price except in the unusual case in which the likely price increase is small and the production cost savings are substantial.

[59] This approach effectively raises defendant's burden when it seeks to defend its merger under an aggregate welfare standard rather than a consumer welfare standard.

procedure.

Some suggest treating efficiencies as an affirmative defense, regardless of the welfare standard, on the ground that doing so would encourage the merging firms to reveal their private information about efficiencies. It is not necessary to put a burden of persuasion on the merging firms to facilitate substantial revelation of their information to the government and court, however. The government has access to the merging firms' information on efficiencies through compulsory process (the second request) and pretrial discovery, and the burden of production placed on the merging firms gives them an incentive to make that information available voluntarily.[60] Nor is it necessary to place a burden of persuasion on the merging firms in order to permit the fact-finder to test the probative value of the defendant's efficiency claims, including the credibility of defendant witnesses, as the example of *Staples* illustrates.[61] Moreover, there is a cost to placing the burden of persuasion on the merging firms to demonstrate efficiencies (treating all efficiency claims as affirmative defenses): it will make it more difficult for the merging firms to successfully prove that mergers will promote competition, and in consequence discourage firms from negotiating some such mergers. On the whole, placing the burden of

[60] The Horizontal Merger Guidelines take a similar view, in requiring that the merging firms "substantiate" efficiency claims so that the enforcement agencies can "verify" them, including their likelihood and magnitude, how they would be achieved, how they would enhance the merged firm's ability and incentive to compete, and why they are merger specific. Although the Guidelines disclaim assigning evidentiary burdens, this language is consistent with placing a burden of production on the merging firms and the burden of persuasion on the government.

[61] That assessment is in general no more difficult than the problem of testing other types of evidence routinely submitted in merger litigation. The merging firms often control much relevant information with respect to entry, yet courts do not insist that the merging firms bear a burden of persuasion when they say that entry would solve the competitive problem; they simply assess the probative value of the evidence submitted by all parties.

persuasion with respect to efficiencies on the merging firms seems at least as likely to discourage good efficiency claims as it is to weed out bad ones.

The allocation of burdens of production and persuasion with respect to efficiencies in horizontal merger analysis is an important question as to which the courts have as yet provided only limited guidance. Although I have sketched a view as to how those burdens should be allocated, it is appropriate to allow the courts to weigh the pros and cons of the range of possibilities. The law in this area is only just developing, and the decisions so far create no pressing need to rush that development. I would again encourage the Antitrust Modernization Commission not to make a recommendation to Congress in this area.