Before the Antitrust Modernization Commission
Testimony of Robert Willig

November 17. 2005

Re: Assessment of U.S. Merger Enforcement Policy

Summary

1. Our current standards for merger enforcement have appropriately adapted to major changes in the economy and in our capabilities and methodologies for analyzing competition, and remain an appropriate platform for subsequent adaptation to continuing change.

2. Important discipline in merger analysis is fostered by the insistence that intervention be founded on the identification of relevant markets in which competition is predicted to be significantly weakened by the merger. Foregoing market definition can lead to systematically wrong results.

3. Where they are available, direct methods of merger analysis, like natural experiments, may provide the best evidence of the anticipated impacts of a merger. In such circumstances, the same direct methods would likely also provide the best evidence for delineation of relevant markets that would be consistent with the analysis of merger impacts. Thus there is no loss and possibly significant gains in reliability from continuing the insistence on the identification of relevant markets.

4. Neither market definition nor the Guidelines compels over-reliance on concentration measures. It is appropriate in our current standards that concentration measures be based on indicators of firms' future competitive significance, be employed for safe harbors and not be used as replacements for analysis of competitive effects.

5. Late stage merger analysis by the agencies often includes influential economic analyses afforded too little transparency. Consequently, there is too little of the valuable dialogue with the parties that so often sharpens the work, corrects errors, broadens perspectives and helps to make the process reliable for the underlying purposes. This occurs particularly where the analyses rely on data acquired from third parties under confidentiality. Can process modifications be found that will maintain needed protection of competitively sensitive information, while permitting greater transparency of influential analyses?

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Re: Assessment of U.S. Merger Enforcement Policy

Good morning, and thank you for the opportunity to appear before you and share some of my views on U.S. merger enforcement policy.

current standards have adapted well and remain an appropriate platform going forward

The conduct and practice of the antitrust analysis of mergers in the U.S. has evolved into an intelligent design. The blueprints for the architecture are best displayed in the 1992 DOJ and FTC Horizontal Merger Guidelines, the efficiencies revision of 1997, and the precursor 1982 DOJ Merger Guidelines. The design that organizes current enforcement policy functions well in today's environment and remains an appropriate platform for subsequent adaptation to continuing change in the economy and in our understanding of it.

The agencies, legal and economics scholars, practitioners and the courts all play significant and interlaced roles in refining and adapting antitrust merger analysis. Within the flexible and quite general framework of the antitrust laws, the standards for merger enforcement have appropriately adapted to major changes in the economy and in our capabilities and methodologies for analyzing competition. Dramatic shifts and advances in the nature of production technology and in the fabric of consumer demands have not altered the importance of competition and not transformed the fundamental economic concepts that best illuminate competition. At the same time, economic understanding has continued to deepen and be guided in new directions by both the changes in the economy and by the continuing progress of productive thinkers in academe, government and antitrust practice. Yet, such important new economic understanding as that forthcoming from sharper econometrics, network models and concepts of multi-sided markets has not proven to be inconsistent with the basics of antitrust merger analysis. Moreover, significant alterations over the last two decades in the workings of governmental regulatory mechanisms, such as in energy, health care, financial and telecommunications markets, have appropriately affected the details of various antitrust analyses of business combinations, without unduly stressing the underlying architecture guiding how merger analysis is to be conducted.

the current fundamental conceptual framework

The fundamental conceptual framework for antitrust merger policy remains sound:

1. There must be no intervention without identification of a competition problem caused by the merger.
2. For justification of intervention, there must be an identification of relevant markets in which competition is predicted to be significantly weakened by the merger. A relevant market is a universe of supply that is vulnerable to a significant profitable shift towards monopoly pricing (with details as per the merger guidelines).
3. Concentration measures may be useful tools for analysis and do serve as clear foundations for safe harbors. However, clear admonitions against conclusory over-reliance on concentration measures should guide the enforcement agencies and be heard by the courts.
4. For justification of intervention, there must be identification of adverse effects on competition predicted to be caused by the merger.
5. For justification of intervention, there must be showing that these effects on competition will withstand substantial mitigation from entry and other dynamics.

6. There must be openness to possible evidence that efficiencies caused by the merger will outweigh the predicted adverse effects on competition.

<u>the continuing importance of market definition</u>

I would like to focus here on the roles played by relevant markets and concentration in antitrust merger analysis. There is a serious argument advanced by some smart observers of the antitrust scene that the construct of relevant market should be viewed as obsolete. I think the basic rationale advanced for this position is that it is now in our capability directly to analyze market power and the impact of a merger on it, rather than indirectly through the steps of considering relevant markets and impacts of mergers on the concentration within them. The argument proceeds, at least implicitly, to emphasize that the indirect approach inevitably introduces the possibility of mistakes that the direct approach would avoid, so it is counterproductive to insist on the steps of market definition and corresponding assessment of impacts on concentration. Despite the appeal of condemning older approaches as dangerously obsolete, in favor of newer and bolder analytic progress, it is my judgment that this would be a grave policy mistake here.

Important discipline in merger analysis is fostered by the insistence that intervention be founded on the identification of relevant markets in which competition is predicted to be significantly weakened by the merger. Of course, if one imagines that direct methods of assessing merger-driven changes in market power would generally work perfectly, then there is no reason to insist on market definition, and no additional discipline in merger analysis could be gained. And indeed, in the hands of the most skilled and responsible analysts, there is relatively little need for the additional discipline provided by any set methodology or guidelines, because the ideal analyst would draw on the strengths of whatever tools are available, as appropriate, including market definition where that would be uniquely salient. However, in the real world of imperfect tools of direct assessment of market power, and of good analysts who are only occasionally perfect in their judgments, important gains are apt to be forthcoming from insistence on market definition.

For example, one seemingly attractive alternative to market definition works from direct assessment of the demand substitutability, the demand cross-effects (like cross-elasticities of demand or diversion ratios), between the merger parties' products. Other things equal, the greater are such cross-effects, the more there might be concern that the merger would result in elevated prices through unilateral effects, and an analyst might wish to dispense with market definition upon such a finding.

However, while there can be critical information about merger impacts to be gleaned from demand cross-effects between the merger parties' products, it is analytically dangerous to found intervention on them alone, without delineating and analyzing the surrounding relevant market. In this appropriately broader context, it may be the case that the parties' products are seen to have ample additional substitutes to discipline their prices post-merger, despite their substitutability with each other.

To illustrate, consider this extreme example: Two gas stations on opposite sides of a traffic circle seek to merge. The diversion ratio between them is 100%, because if one of them were to raise its gas price, all customers would circle around to the other one. The demand cross-effects between them indicate extremely high substitutability. The conclusion might be drawn that the merger between them would significantly raise their market power, and permit a unilateral competitive effect of significantly elevated prices. However, an insistence on identification of the relevant market might well properly reverse that conclusion. The hypothetical monopolist test for market definition would start by asking whether the northern gas station could profit by raising its price say 5%, and answering no, due to substitution to the southern gas station on the other side of the traffic circle. Then the putative relevant market would be comprised of the two gas stations, but the analytic process would not be over. Under the Guidelines, the next question must be addressed – would it be profitable for the hypothetical monopolist over both the northern and southern gas stations to raise prices say 5%? Here the answer may be yes, so that the traffic circle constitutes a relevant market area for gas stations, or the answer may be no because so many customers would drive a bit down the road for gas without elevated prices. If there is a broader market with lots of gas stations as market participants, then insisting on the step of market definition will have avoided counterproductive intervention in the merger. The merger would not result in significantly higher prices, due to the competition from the other market participants, and it is a fair inference that the merger is motivated by sound business rationales (since it is evidently not motivated by the profitable opportunity to raise prices).

The more general conclusion is that the requirement of market definition creates the imperative for consideration of sources of competition beyond the parties' own products, along with the need to generate some calibration of the strength of that additional competition. These steps are ones that any aware, highly skilled, responsible and careful analyst would undertake anyway. But in an inevitably imperfect world, requiring market definition in essence mandates this degree of discipline in the merger review process. Furthermore, requiring market definition via the conceptual approach of the Guidelines (smallest universe such that the 5% price rise for the hypothetical monopolist would be profitable) calibrates the extent of relevant markets in a fashion that is consistent across cases, and thereby also consistently calibrates the measures of concentration in relevant markets in different cases.

Critics of the requirement of market definition emphasize situations where direct analysis is likely to be more reliable in predicting the impacts of a merger. An important example is direct analysis by means of what are labeled "natural experiments." These have proven to be especially reliable and informative avenues for empirical analysis throughout recent research in many economics fields.

Suppose, as an illustration, that some areas have one super-store, other areas have two super-store competitors and still others have three, and that these super-store competitors' sales are local to their areas. Suppose too that whether there are one, two or three super-store competitors is for reasons that have nothing to do with costs or other determinants of prices. Finally, suppose that it is observed that prices are highest where there is only one super-store, significantly lower where there are three, and in the middle where there are two super-stores. Then it might be a reliable direct conclusion that a merger between super-stores would result in elevated prices where the merger would reduce the number of super-store competitors from three to two or from two to one. This conclusion would not require the step of product market definition, despite the possibility that there are lots of other sorts of seeming competitors, that are not super-stores. And an insistence on market definition through conventional means might well have resulted in the delineation of inaccurately broad relevant markets in which the merger would have seemed to have had little significance.

In my view, natural experiments and other forms of direct analysis may well in certain circumstances be feasible and persuasively reliable. In such instances, there need not be a conflict or any inconsistency between the direct analysis and the process of merger analysis that includes market definition. In the example above, the analyst would be driven to conclude from the same natural experiment that the relevant product market is confined to super-stores. Despite other evidence pointing towards inclusion of the other kinds of sellers, in this example the contrary evidence supporting the narrow market confined to super-stores would have to be seen as the best evidence. The right conclusion would be that the relevant market here is best defined as an implication of the natural-experiment analysis. As such, while the relevant market did not add anything to the analysis here, it need not stand in the way of the right result either. As long as direct analysis is permitted to play its role in market definition as well as in other phases of the merger review, there is no choice that needs to be made philosophically or methodologically. Best evidence should be the standard, and as such there is only up-side from a requirement that relevant markets be delineated for antitrust intervention.

neither market definition nor the Guidelines compels over-reliance on concentration measures.

With all this said about market definition, it is important to speak to the connection with the use of measures of concentration, however briefly, but nonetheless emphatically. Market definition identifies a universe of market participants whose competition with the parties must be considered in the merger analysis. It does delineate a context for checking whether concentration measures indicate that the merger falls into a safe harbor. But market definition does not compel over-reliance on concentration measurements for the rationale for enforcement action. The Guidelines mandate that market participants' shares be measured in a fashion that makes them indicative of future competitive significance, and in my experience that mandate is taken seriously by the agencies. This operates in both directions – sometimes indicating that competitive significance is far greater than current sales share would suggest, and sometimes showing that current sales share substantially overstates future competitive significance. This could be the case where there are discernable trends affecting firms' competitive significance, where firms can readily expand or contract their sales as conditions warrant, where some market participants are capacity bound, where positions in production assets or complementary markets are important for competitive significance etc. Of course, the guidelines mandate that even high measures of concentration, appropriately measured, are not nearly enough of a foundation for intervention in a merger. Instead, competitive effects must be shown, along with resistence to entry and other dynamic forms of competitive reaction. Finally, the available data on second requests and enforcement actions show that both early and late stage agency decisions are substantially based on far more factors and dimensions than concentration measures alone.

influential agency economic analyses are afforded too little transparency

I would like to utilize this opportunity to articulate a sometimes-significant problem with the process of antitrust merger analysis – even though I am not sanguine that a practical solution can be found. The problem is the lack of transparency accorded to the economic analyses performed by the agencies that sometimes are quite influential in agency decisions. The agencies declare their dedication to the value of transparency in their merger reviews, and to a valuable extent they act on it. The agencies do generally (though not always, to be sure) keep the parties apprised of the progress of their thinking and the nature of their competition concerns. The agencies are highly open to presentations by the parties, and will generally (again, not always) communicate their reactions and reservations about what they have heard, in due course. Even so, the overall process is full of delays, frustrations and costs to the businesses involved, and I know that other witnesses before the Commission are focusing on these concerns.

As economic analysis has grown in its role and significance to the merger analytic process, both inside the agencies and by the parties, it has become of considerable importance that dedication to the value of transparency extend to this domain as well. However, there is a fundamental stumbling block. Economic analysis at the agencies often employs data that were collected from third parties under confidentiality arrangements. In some instances, the analysis can be conducted, at least indicatively, with data confined to the parties' own production, and the outside economists can often attain access to both parties' data for such purposes. But often enough, the industry level analysis needs in addition data from other market participants. Here, the agency typically will not permit the outside economists access to the data or even to the statistical analyses based in part on the data, because of the confidentiality.

This lack of transparency can lead and has led to situations where agency analyses and conclusions are not subjected to the valuable dialogue with the parties that so often sharpens the work, corrects errors, broadens perspectives and helps to make the process reliable for the underlying purposes. And as economic tools continue to gain prominence and influence, this force towards unreliability of outcomes of the biggest and most challenging matters will only become more serious.

From what direction might a solution come? One model is the protection of confidentiality of data that is applied in litigation. Here, each side's experts and outside counsel have access to competitively sensitive information only under highly restrictive protective orders. Nevertheless, the access is sufficient for the conduct of analyses that make complete use of the necessary data. Is there some way that the agencies could collect third party information and make it available to outsiders working for the merging parties with equivalent protections?

Another model might allow designated access to third party data, but only where those data were sufficiently aggregated, transformed or disguised so that they no longer had any competitive sensitivity. While this restriction would surely limit the usefulness of the data, it would not necessarily eliminate all usefulness for the purposes of econometric analysis. There are precedents for such treatment of confidential data for econometric use from other government agencies, e.g. the Census Bureau.

In any event, my awareness of the problem is far clearer than my view of a solution, but I thank you for the opportunity to share my perception of this issue with you. And I thank you for your attention and your consideration of my overall views on antitrust merger analysis that I have been able to express. Good luck on your efforts and thank you for taking your challenges on.