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Panel I: Efficiencies/Dynamic Analysis/ Integrated Analysis

Moderators: Alden F. Abbott and Mary T. Coleman(FTC)

Panel: J. Mark Gidley (White & Case)
Ilene Knable Gotts (Wachtell, Lipton, Rosen & Katz)
William J. Kolasky (Wilmer Cutler Pickering)
Robert Pitofsky (Georgetown University)
David T. Scheffman (LECG)
Joseph J. Simons (Paul, Weiss, Rifkind, Wharton & Garrison)
Vincent Verouden (EC/DG Comp.)

Panel II: Economists and Lawyers Roundtable

Moderator: R. Hewitt Pate (DOJ)

Panel: William Baer (Arnold & Porter)
Jonathan B. Baker (American University
Wayne D. "Dale" Collins (Shearman & Sterling) James Loftis (Gibson, Dunn & Crutcher) James F. Rill (Howrey & Simon)
Daniel L. Rubinfeld (University of California, Berkeley)
Robert D. Willig (Princeton University)
Dennis W. Carlton (Univ. of Chicago)

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P R O C E E D I N G S

MR. ABBOTT: Good morning. Welcome to the third day of a Joint FTC/DOJ Workshop on Merger Enforcement. I'm Alden Abbott, Associate Director for Policy and Coordination in the FTC's Bureau of Competition.

I am joined here by the co-moderator for our panel, Dr. Mary Coleman, Deputy Director of the FTC's Bureau of Economics.

Thus far, workshop panels have focused on discrete parts of the Guidelines: Market definition, concentration, competitive effects and entry. Several commentators, however, have noted that it would be a mistake to view individual Guidelines provisions in isolation.

However, the implications of such statements that the Guidelines provisions should be viewed holistically, to use the New Age term, with simultaneous consideration of different factors that enter into a Guidelines analysis, have not been developed.

The aim of this morning's panel, entitled Efficiencies, Dynamic Analysis and Integrated Analysis, is to explore what it means to carry out such a holistic or integrated analysis. The panel will also focus on efficiencies and dynamic considerations, with particular

attention to their role in the overall competitive assessment of a proposed merger.

We are fortunate to have a true all star cast assigned to assist us in carrying out our daunting task. Their academic and professional laurels are so impressive, we could take up the entire morning recounting them. Given the time constraints, however, I will refrain from doing so. But I will note their key affiliations.

Our first speaker will be Dr. David Scheffman, who is a recidivist, already having served on the panel, former Director of the FTC's Bureau of Competition, currently a director at LECG and Adjunct Professor at the Owen Graduate School of Management at Vanderbilt University.

Dave, I hope, will tell us what this integrated approach is all about and help dispel the fog and give us a clear sky. Dave will be followed in order by Joe Simons, former Director of the FTC's Bureau of Competition, and currently co-chair of the Antitrust Group at Paul, Weiss, Rifkind, Wharton & Garrison.

Joe will be followed, again in order, by Mark Gidley, co-head of White & Case's antitrust group, and a former Acting Assistant Attorney General and Deputy Assistant Attorney General for Antitrust.

Mark will be followed by Ilene Gotts, a partner at Wachtell, Lipton, Rosen & Katz, who has held various ABA Antitrust Section leadership positions, including membership on the section counsel currently.

Bill Kolasky, co-chair of Wilmer, Cutler & Pickering's antitrust and competition practice group, and a former Deputy Assistant Attorney General for antitrust, will follow Ilene.

Then we're saving our superstar for near the end, the Honorable Robert Pitofsky, former FTC Chairman and Dean of Georgetown Law School, currently a professor at Georgetown and of counsel at Arnold & Porter. And he will give us the big picture to put everything together for us, we hope.

And then our panel will end on an international comparative note with a presentation by Dr. Vincent Verouden, who has been an economist at the European Commission's DG competition since 2000, and Dr. Verouden has already spoken, and we're delighted to have his comparative perspective. And he will undoubtedly enlighten us on EC Merger Guidelines issues.

After our seven panelists have spoken, we will have a brief 10-minute break followed by a discussion and question-and-answer session among the presenters and moderators. Given the fact that at least some of these

speakers I know are not shy, Mary and I look forward to a lively and thought provoking session.

So, Dave, will you lead off, please?

DR. SCHEFFMAN: Yes. I'll try and be a little thought provoking or obnoxious as I usually am, rather than just talk -- and I will talk about integrated analysis, but I'm going to first talk about efficiencies -- can we get this slide up so everyone can see?

I thought we'd give a report card since I left the agency not that long ago and talk about how I think the agencies are doing -- obviously, I have much more experience at the FTC -- with respect to efficiencies.

It's hard to tell, because you don't see many tough cases with efficiencies compared, say, to the '80s. I think that's because the outside believes that efficiencies aren't given much weight and they advise their clients not to try them. That's well known and a well-known problem.

With all respect to Chairman Pitofsky, who I have the highest regard for, baby foods was not a helpful development, and I'm sure he will respond. I wasn't involved in the case, and maybe I misunderstood the facts, but it's not surprising that it's not most economists' favorite case. Nor is it a favorite of those in favor of efficiencies, I don't think, although I can't

say that, because Bob did promulgate, you know, was an instigator of the '97 revision and does believe in efficiencies. So I'd be interested in what he has to say.

There are some good things about baby food, I think, such as it's good to have a clear decision that when three to two is a real three to two. It is a very high hurdle, and I think most economists in the mainstream would agree that that's where the really high hurdle should be. I think as Chairman Muris has often said, and he worked on baby food, his concern with baby food was that it wasn't really three to two. It was really like one to two or 3.1 to two, 2.1 to two.

What I've heard from the parties, but I don't know a lot about this, is the ex poste story is not a pretty one. I know the FTC is engaged in various retrospectives on hospitals. I urged them to look at some of these cases where efficiencies were a significant issue and look at what happens.

My favorite case, one in which I was an expert soon after leaving the FTC and was one of the FTC's and Ann Malester's best cases, was the tank ammo case. This was the two to one defense merger case, a big victory for the FTC. Everyone has known after that it turned out exactly opposite from what the FTC said it would. And so

I think my view of the track record, from anecdotal evidence, on how the agencies have treated cases that had serious efficiency claims is not good. But, you know, the research has yet to be done.

However, the record is not as bad on efficiencies as all that. Efficiencies are important. They're more important than people and counselors think they are, but not in the Guideline's sense. One thing is that much more the case now than it was in the '80s, is that the agencies rely on customer opinions. And so in industrial mergers in which you have a relatively small number of sophisticated customers, even in a pretty concentrated merger, if the customers say we're not concerned, it's unusual that the agencies will challenge. That has locked into it efficiencies and other considerations. I think those are the mergers which I'm quite comfortable the agencies almost always get right.

So in those cases I'm not so worried about the efficiencies. Another way you could say it, if the suppliers can't convince the customers of the efficiencies when they have big, sophisticated customers, then they haven't fulfilled their burden and the merger is likely to be challenged and it probably should be.

The real problems are in the cases, all the cases where you don't have a relatively small number of

sophisticated representative customers -- the oil industry, branded products mergers, supermarkets, et cetera. Those are cases where you have middlemen or lots of customers, where you don't really have sophisticated customers to speak for the benefits or potential costs of the deal. I think that's where the real problem is. I think what we've done in oil for 20 years, and it's been going on a long time, in the way efficiencies have been treated has really been quite counterproductive. I think everyone, including FTC staff, believes that there have been substantial efficiencies gained from a lot of the oil mergers. Nonetheless, the efficiencies are usually not given much weight in oil merger enforcement. It's still, as it has been for 20 years, largely a structural enforcement policy.

I will say, the other way that efficiencies count is that, it affects remedies, which I don’t think is really recognized. When staff and the agencies think that, well, actually this is a good deal, in a general sense not in specific Guideline sense, and are crafting remedies that may impact the achievement of the benefits in the deal, you'll see in lots of consents kind of exotic, flexible consents at the agencies. In some cases, my view of that of what's going on is the agencies are crafting things to alleviate the competitive problems

but in a way that allows the potential benefits of the deals to go forward.

But efficiencies can be very important. Efficiencies sometimes, are part of the reason why you don't get a second request. And in close cases, in cases in which it's really just a structural case where you could go forward because it’s a five to four merger, but where you don't have complaining customers. If you've got a good story about why the merger is taking place, that can be part of the reason why either you don't get a second request or why a case is closed. And a good example of an interesting case on efficiencies is drug wholesalers II, which was an interesting situation where the Commission had a prima facie case to be able to block the merger that came back second time, and for lots of complicated reasons which I don't fully understand and I was there near the end –- the Commission did not block it. But certainly part of it was a belief within the Commission staff that there were benefits of the mergers, that just having two mergers in that industry going from four to two in the case that was litigated was a no go proposition. The efficiencies were clearly a significant part of the reason why drug wholesalers II matter was cleared.

And I'll get to the integrated analysis, along

with the argument and belief that the merger really wasn't going to be anticompetitive anyway, in part because it was going to be efficient. It was going to strengthen the smaller competitor.

Okay. How do the agencies actually do things? Well, they do it really the way the Guidelines say, which is part of the problem. There really is a sliding scale in which if you've got a case where the staff has a pretty strong belief that the matter is anticompetitive, there's no efficiency is going to turn that round. It really has to do with the stronger the belief by the staff, and their decisions are usually ratified, and obviously the belief by the ultimate decision maker about the likely anticompetitive effects of the deal, the less weight efficiencies get.

So efficiencies really are in play in the gray area where you've got a case where there isn't a strong belief and basis for believing the merger is anticompetitive.

This is the reason why we need to get more integrated analysis because the way the efficiencies actually get treated in the more difficult cases, it's not really the proper way. That is, you know, one of the reasons why the merger might not be anticompetitive is because it's efficient. Talk about that in a minute.

What's happened with the Merger Guidelines, I think it's probably more at the FTC, because the FTC has litigated the efficiencies provisions probably more than DOJ, is unfortunately is the staff builds a prima facie case that the parties can't win on the Merger Guidelines efficiencies checklist. It's not cognizable, it's not merger-specific, it's not variable cost. Gabe Dagen leads that effort for the financial analysts, and he does a very good job on that, that's his job in a way for the client. But if we have to go to court we have to be able to show that, you know, they're not going to be able to get through the Guidelines efficiencies checklist.

The problem with that is that gets the focus on the efficiencies on litigation and disproving the efficiencies. The question is, is anyone really looking at whether there are some real efficiencies here, folks? And that was something I tried to do at the FTC, with mixed success.

There aren't procedures and incentives really to look for real efficiencies, at least within the FTC. I don't know about the DOJ. I don't say it doesn't happen, but it happens sort of depending on which staffers you get on a case. Because otherwise, again, what the staff is mainly looking, and that's partly on the basis for the client, to be able to show that you can

disprove the efficiency claims of the parties if you have to go to court.

And with the emphasis on disproving efficiencies, not surprisingly, there's not a lot of emphasis on finding efficiencies. But is this really a good merger? Even if we maybe could disprove the efficiencies under the Guidelines test, is this really a good deal, okay?

And we are proud of transparency, and this is a real benefit of the transparency that we tried to increase, the Commission tried to increase. But this is the part where it's been least successful. In my experience, there's the least communication between the parties and the staff about the efficiencies claim. What happens is, and I don't think the outside understands this, the staff looks at the documents, deposes the people, gets enough so that they think they could disprove the efficiencies claim under the Guidelines. And there's usually nothing comes back over the net from the parties. It's like the other side doesn't even know what's happened, right? Your opponent has made a prima facie case that your efficiencies don't count.

Now, what we found in a couple of instances where we actually required some transparency between the staff and the parties, is that the staff didn't always

have it right, particularly on whether the efficiency was merger-specific or what would happen but for the merger. But the efficiency arguments, often really don't get tested. And that's a fault of the parties, in part. It's a fault of the staff in not always being open, but the parties have to push.

They really have to be serious -- they have to say, okay, what is your basis for thinking that this is not merger specific, that something's going to happen independent of the merger, et cetera. The parties have to test that to understand what the basis of the staff's opinion is in order to come back with and answer. This is the one situation in which the parties actually have information that the staff doesn't, which is usually not the case on competitive effects. But the staff doesn't get this information. So the parties really have to engage the staff and to the extent they can, request, demand transparency. What is staff's real basis for it's conclusion this efficiency isn't merger specific, et cetera? Because when you press on it, you might find that the basis isn't there, even though the staff has good reason to believe what they believe, they might not have the facts right.

Okay. We learned a lot from the efficiencies roundtable. I don't know that it's had any effect, but I

think we learned, you know, the merger consulting companies have certainly not helped the consideration of efficiencies with all the articles arguing that the typical merger is not, quote, "successful." Well, I think -- I don't know that it came through in the roundtable, but Paul Pautler has a good paper on that issue, and I've looked at lots of literature, and it's important to understand what that literature means. I think that literature is right, but you have to be careful about what you think it means for what we do in antitrust.

That is, clearly the leading reason why mergers aren't successful is because the acquirer pays too much. That's not an antitrust issue. You can have a perfectly efficient merger. They may have paid too much. It's the winner's curse sort of thing. That's the primary reason why mergers are not “successful.” That's the main reason.

But another important reason, which is related to what we actually do, has been recognized in recent years. Another important reason why mergers are not successful is that the mergers lose revenue that they didn't expect. That is, they lose customers and business. In a horizontal merger, why? Well, it might be because it's anticompetitive or could be

anticompetitive, but it could be because the customers actually react adversely to the merger for other reasons. That's related to reliance on customer opinions and things like that, so that reason is important. It does fit with what we do. It does indicate how -- it reemphasizes how important sophisticated customer opinions are.

The roundtable clearly indicates, other things equal, that horizontal mergers are more likely to be successful and efficient, you know, if there is “fit” -- all the stuff about fit and being in a similar business, da, da, da. The literature is very clear and always has been on that, and that goes back to the Scherer and Ravenscraft papers.

The other thing which is true, if you listen carefully, and it's that straightforward cost savings are generally realized. If you look at what companies report to the shareholders, what they report to the 10-K, what they report to the street, you know, they say we're going to reach these cost reductions. And on average, in fact, much more than on average these days, they do, if those are costs savings which aren't pie in the sky but standard sort of consolidation savings. So the cost savings that we worry about, cost reductions we worry about, in horizontal mergers, they're, you know, you need

a basis for believing that they're there, obviously, and how they're going to achieve them. But they're going to do so -- you can have pretty high confidence if you have some basis that they're going to actually be realized.

The other thing from the efficiencies roundtable is that planning and implementation is really important. That's a leading reason why mergers aren't successful. That has something to do with what we do. Gun jumping is a problem despite -- I don't think that the efficiencies roundtable was successful in explicating that issue. Gun jumping I continue to believe is a significant issue. It is why companies can't do as much planning as probably even they could do if they didn't have such conservative counseling. And it also indicates what the agencies should be looking at in terms of some evidence of serious planning of how the merger is going to be implemented to believe that the efficiencies are going to be realized.

Okay. How do efficiencies fit into the analysis? This gets to the integrated approach. Efficiencies are related to -- a merger that's in a five to four industry without unilateral effects is significant -- one point of the merger is to become significantly more efficient, and not dominant. This is almost a prima facie case for economists. Why isn't the

industry going to be more competitive? I mean, it might not be. But you need a pretty convincing story about why not. So efficiencies obviously impact the competitive analysis. The ideal case, and one I think, that will get a merger through, where both staffs at both agencies, lawyers and economists, say, well, yes, that's a pretty good efficiency story is where you've got a manufacturing merger with a combination of batch and continuous production processes, so you can do lots of interesting things in terms of getting more output out of the same facilities, et cetera. You can get higher capacity if it's an industry where there is not a viable theory that you're going to significantly reduce capacity utilization because the costs of reduced capacity utilization are too small, or too large. This is like the oil industry, but that's not batch and continuous.

Then you've got, well, how is the merger going to be anticompetitive? The party is going to produce more almost surely as a result of the merger. That's not to say you might not have other reasons to believe that the merger is problematic, but you should have some strong reasons to believe, say, in a five to four merger why this merger is going to be problematic. So efficiencies are important.

Let me begin with the integrated analysis.

First what we have to remember -- and this is not the way the law works at all, and it's not the way the enforcement agencies really work in practice, is that we define markets in antitrust and then we do the analysis after that.

Well, not all markets are alike, and the real basis of the market is not equally strong. This is not recognized. The markets are taken as given to us clearly. This is the way the courts decide, although sometimes the reason why the courts reject cases based on market definition is for squishy reasons that probably don't have to do with market definition. But these things are all related. In particular, weaknesses in market definition will usually spill over into competitive effects. That was true in cruises, for example, and Joe will talk about this more in a minute.

All these things have to fit together. The weaknesses in market definition are important in competitive effects analysis. I think what people on the outside don't understand is that you're never going to win an argument with the staff on market definition in a hard case. It's not that you should give it up, but you will start talking about, well, if this is your market, given the defects in that market definition, this is why the competitive effects that you're worried about are not

going to occur.

Okay. What efficiencies should count? I have long believed –- going back to the '80s and the papers that were written at the FTC, like Fred Johnson's paper -- that this whole idea of passthrough incremental costs and passthrough is a whole red herring. I don't think it should be important in how the agencies think about things -- it's of some relevance, but it's not the key issue. The key issue in the way the agencies look at efficiencies is really the sliding scale.

Joe Simons is going to talk more about a more sophisticated, in my view sensible approach. Should fixed costs count? Of course. Bill Kolasky will talk about that. Dave Painter has a nice presentation at the efficiencies roundtable about exactly why anyone who works with real world companies and looks at their pro formas include fixed costs. I teach MBAs and work with lots of companies, do they count their fixed costs in their pro formas and in their decisions? Of course they do. There are good economic, sound economic reasons for that, and other people will talk more about that.

Joe Simons will talk more about the integrated approach.

Let me finally talk about dynamic competition, which hasn't been so prominent lately. It is an

important issue, and it's going to come back. I think it's very interesting to look at what happened to dot.com. There were all sorts of consolidations in dot.com mergers that, you know, if the agencies wouldn't have been so busy when the mergers happened, they would have stopped them. There were a lot of two to one and three to two mergers that looked, you know, pretty problematic based on the way the agencies look at things.

They were let go just because the mergers were small and the agencies were very busy. Those mergers present dynamic competition issues. The Commission faced these issues in Monster/Hot Jobs, which I think was probably a good case but presented some very difficult issues. We'll see other deals involving these dynamic competition issues, because the industry is based on IP and in dynamic economy. We're going to see more of these, and the agencies really don't know how to analyze them, in my opinion. And I've more than used my time. Thank you.

MR. ABBOTT: Thank you, Dave. You've certainly given us a lot of food for thought and digestion. And now Joe Simons will tell us -- give us a chart which will explain all future efficiency analyses and solve our problems, we hope.

MR. SIMONS: Well, that's a little ambitious, I

think. First, I just want to thank Alden and Mary for putting this panel together. I know they put in a lot of hard work, and I just want to thank them for that and for inviting me to appear here today.

What I'm going to do, what I have in mind really is to present what I think is actually a fairly simple and straightforward way of doing an integrated approach to analysis of anticompetitive effects and efficiencies in mergers. And here's what I have in mind.

Let me be very specific about the first principle applied. I think that's really important. If you don't know what it is you're looking for, it's kind of hard to find it. So the first principle is really important, and it is prohibiting mergers that reduce consumer welfare. That principle applies equally to competitive effects and efficiencies. And the ultimate exercise basically is to make a judgment or prediction about the overall effects of a merger over a reasonably foreseeable period of time, two, three, five, years something like that.

Now, you know, based on what Dave said just a few minutes ago, obviously this is not an easy thing to do in practice. But at least if you know what direction you're moving in and you know where you're supposed to be going, then you have a better chance of getting there.

Even if you can't get really close with the tools at hand that you have today, it's better to create a framework and to develop the tools over time. I think that has really been shown to work with respect to the Guidelines that were issued in 1982. For those of you who are old enough to remember, when those Guidelines first came out, there was a hue and cry that those Guidelines were way too theoretic, particularly the market definition paradigm, too theoretic, completely nonoperational.

Today, with the advancements that we've seen in merger analysis, I would say that the market definition paradigm is probably the most practical tool in all of antitrust, and when it started out, it was nothing. So the only improvement area is fairly theoretical, but I think it can be used in practice, at least as a tool is a type of a sensitivity analysis to see how things fit in and the relative importance.

So purely from a theoretical point of view then, the way to determine whether the overall effect of a merger is to reduce competition, or reduce consumer welfare, is to perform what I refer to as a risk-adjusted, net present value calculation. In other words, what we do is we estimate the magnitude of any price effect, and by "price effect," I'm including quality-

adjusted price, innovation, et cetera. You estimate the magnitude of that price effect, the probability that it's going to be realized, its timing and its duration, and you do the same for efficiencies. So that is, you estimate the magnitude of the efficiencies, their likely effect on price, the likelihood that those efficiencies are going to be realized, their timing, and their duration. And then you see what the expected costs and the expected benefits to consumers are over time, and you make a net present value calculation.

So whether the merger is challenged or not depends on whether the NPV is positive or negative for the consumers. It's fairly straightforward. It's a tool that's used every day in the business world. And I have an illustration if we can put that slide up.

(Slide.)

Okay. This is just a spreadsheet, and it involves the following example. Suppose we are presented with a potential merger of to widget producers and we conclude as follows. After a lengthy investigation of witnesses, documents, third parties, everybody, we conclude that the market is widgets with an 80 percent probability.

We conclude that entry will not occur for two years, also with an 80 percent probability, and we

conclude that the anticompetitive effects given the market definition and the entry conclusions, are that we're expecting a 10 percent rise in price for the first two years, and we expect that within 80 percent probability.

On the efficiency side, we are expecting that marginal costs will decline and impact price by 2 percent. We're expecting that with a 70 percent probability and that begins in year two and continues through year 5.

We concluded that pecuniary costs would decline and impact price by 1 percent, with a 70 percent probability beginning in year one and continuing through year 5. Then we also concluded that fixed costs would decline and impact price by 1 percent with a 70 percent probability, that beginning in year three, and continuing through year 5.

All right. So these assumptions are all summarized on the spreadsheet, which performs the net present value calculation for that flow of positive and negative benefits to the consumer that result from this hypothetical transaction.

It shows that even though the merger is projected to raise price by 10 percent for two years, the net projected effect on consumers is actually positive.

So we'll just through this. If you look on the left-hand side, you see we have competitive effects, market definition, entry, anticompetitive effects, all with probabilities of .8. Those are determined by each other, so the probabilities add up, and the total probability is 51 percent. The potential harm is 10 percent. Multiply that by the probability and you get an expected harm to the consumer of 5.1 percent, and that appears over the first two years so you see the columns on the right, year one has a negative 5.1 and year two has a negative 5.1, and then years three, four, and five shows zeroes.

In efficiencies the same thing. The marginal cost probability is 70 percent. The same for pecuniary benefit and the same for fixed cost. The expect harm is 2 percent from marginal costs and pecuniary benefits is 1 and fixed costs is two, and then the expected value of those benefits given the risk, and then the columns to the right show how those play out over time, given the assumptions in the hypothetical.

And then just adding up the total effects down the columns for year one, two, three, four, 5, you see that the expected effect in year one is a 4.4 percent increase in price; for year two is a 3 percent increase in price; and then years three, four and 5, the benefits are to the consumers 3.5 percent each year.

And when you do a net present value calculation, you see at the bottom there in the lower left-hand corner, if you can see that, it's positively slightly about 1 percent, or .68.

One thing more, I took a discount rate of 10 -- I basically just picked that out of the air. Obviously that has a significant impact on whether the result is positive or negative. I haven't thought real hard about, you know, what the discount should be, except for the fact that it probably relates to the market in question and who the consumers are. Different consumers are going to have different discount rates applicable to them probably.

I don't mean by putting this chart up here and having, you know, somewhat precise numbers like 5.1, to suggest that, you know, we should do a calculation with a great degree of mathematical precision. We don't really have the tools to do that, at least not yet.

On the other hand, what I think this allows you to do is to see in a broad way what's going on, to be cognizant of the ultimate purpose of this exercise, and perhaps most importantly, be transparent about the assumptions that we're making in the analysis. And by being transparent, I think we can expose some inconsistencies in what we may be doing and not realizing

some flaws, and I think we can also provide incentives to develop new techniques that will make this kind of framework more practical.

Among other things, I think what this approach does or this structure does is help to define what efficiencies are cognizable, how to evaluate them, and more significantly, how to weigh them, which I think is something that's seriously missing now.

And just as importantly, it does the same thing for competitive effects. There's been this debate in the antitrust community about, well, what's the standard for proving efficiencies? But we've never really tied that to, well, what's the standard for proving competitive effects? And do the two relate to each other at all? And if you look at this type of analysis, you'll see that they directly relate to each other.

So it's not only the size of the competitive effect that's significant, it's the likelihood that it's going to occur and the duration. That then impacts well, how long, how high, how much passthrough does there have to be to make the efficiencies offset those perceived harms?

So I think what this type of analysis demonstrates really is the larger, the more likely, and the longer the adverse competitive effect is, the larger,

the more likely, and the longer must be the offsetting efficiency effects, and the weighting is then determined by the NPV calculation.

One of the things that is demonstrated by this type of example is fixed costs. If you look at the fixed costs, you see that they're occurring by assumption here in years three through 5, and what it shows is they really can be determinative, and they shouldn't be ignored or treated with the back of the hand, which I think is the tendency now.

I mean, basically, what would happen is, people would say yeah, we got these big fixed cost savings, and the agency folks will say, yeah, that's really nice and maybe you do, but, you know, those really get little weight. Well, you know, how much weight should they get? There's really no mechanism to kind of figure out how important they are. And so, I think this really helps with that.

And the other thing that this kind of focuses your attention on -- and Dave made a reference to this -- is the probabilities of the anticompetitive effect, particularly if you're talking about analysis that's kind of like compartmentalized.

So we do a market definition, then we do a competitive effects analysis, assuming that market

definition, and there's some risk associated with each of those, and I think that kind of tends to get lost, that once we conclude the market is X, we're making kind of like a subconscious assumption that it's X with 100 percent probability, and that's really not the case.

So I think this type of analysis kind of helps to expose what's really being assumed, and then the magnitude of the effects versus the efficiencies. And I think something like this would really help get us over the hump that we find ourselves at now. What happens today basically is when somebody comes in with a merger, they do their efficiencies analysis, the parties do, and as Dave said, it goes over the net to the staff, and it really never comes back. And I think the parties don't really pitch it that much, and I think that's true for the following reason.

I think they intuitively understand that it's not going to save an otherwise anticompetitive merger. By the same token, they don’t understand that if the staff has some serious doubts about the confidence of, you know, their projection of an anticompetitive effect, the fact that the merger has efficiencies associated with it will make the staff feel more comfortable about not challenging the merger. And so there's really no need in that kind of a circumstance to go back and forth over the

net.

The problem, though, is that the efficiencies really are playing a very little role in the merger investigation, and I think that's something that needs to be rectified. And hopefully, this type of structure, you know, can provide some context in which to do that.

Thanks.

MR. ABBOTT: Thank you, Joe, for that succinct presentation. And it's the first time I've seen such an effort, as I say, to rank the probabilities of the different factors going into net consumer welfare analysis in sort of a simple manner. So we'll see if that inspires some of our speakers.

Now we turn to Mark Gidley, who is borrowing from Voltaire and Professor Pangloss. I know he has a paper for distribution you may want to pick up outside at the entrance entitled "Misuse of the `Merger-Specific' Requirement: Merger Analysis is Not the Search for the Best of All Possible Worlds."

Mark, on that literary note, please proceed.

MR. GIDLEY: Thank you very much, Alden. And let me say, first it's good to be amongst you. I see a lot of old friends. I've had the pleasure of litigating five merger cases since I left the DOJ, with some success and with some failure, and I may acknowledge that as I go

through my remarks.

I would also say that I come down on the side of Spinoza on the issue posed by Candide, but I won't expound on that today. I do turn out to be an optimist.

My main point in citing Professor Pangloss's oft-attributed comment is that I don't contend, and I don't think most people contend, but unfortunately I think this is the way it plays out sometimes in the conference rooms of both agencies, that merger analysis is the search for the best sort of Platonic ideal transaction that the parties could ever enter into. Human beings will never get there, and I think that I really come down on the side of an analysis that's very similar to what Joe is proposing: A net assessment of the pro and anticompetitive effects with a serious consideration of efficiency.

Segueing into what I'd like to address for a few minutes today, I want to talk about the 1997 Guidelines and the emphasis on merger specificity, which is really to my mind one of the new hallmarks of the 1997 Section four.

And I was struck a little bit by our earlier panelist, David Scheffman. In my own experience and maybe in my own conference rooms as we prepare for meetings with the government, we've tended to see Section four of

the 1997 Guidelines as something of an obstacle course out of the Marine Corps. You know, your efficiency argument and your beautiful spreadsheet that actually analyzed the merger on going out five or 7 years, the nail has to go through the rope that's hanging over the net, and it's got to go over the 30-foot wall of merger specificity. It's got to go meet this, it's got to meet that to become cognizable. And in the real world, they're just efficiencies, and they're either likely or they're unlikely. And undoubtedly, people will from time to time bring to the agencies efficiencies that aren't real world or that they don't tell their businesspeople or that they didn't get board approval for, and all of that is relevant.

But what I'd like to focus today on is the language of merger specificity, and in my own work on this paper, I found that the actual language of the 1997 Guidelines is not the way we practitioners or the government officials use the phrase "merger-specific."

In general, the phrase "merger-specific" is really used as an epithet. You might have very good efficiencies that your deal really will cause, that will really cause these efficiencies. But somebody will say, well, they're not merger-specific. And that's it. And with the back of the hand, that invocation phrase,

oftentimes even private practitioners back-off bona fide efficiencies. I hope to back-off of that phrase ourselves today in the discussion.

I start by acknowledging my own sinfulness in words. I sat at the Justice Department when we did the 1992 Guidelines, and I think we really punted on efficiencies. We took on our clear and convincing evidence, but we really didn't analyze efficiencies. All of our efforts and brainpower -- and there was a lot of brainpower applied -- was on competitive effects, and I think that was probably all the bandwidth the human beings at the agencies had in 1992. We really didn't have the bandwidth to take on efficiencies.

So my compliments to Chairman Pitofsky and others for in 1997 trying to explicate what efficiencies we're going to recognize. So I think to that extent, the 1997 Guidelines were a good evolution, but I think they're a stopping point on the journey. And now, with seven years of experience, particularly with merger-specificity, we can really say what's worked and what's not worked.

I have a slide that's just the language, Alden, of paragraph three from Section four of the Guidelines that I thought I would just put up.

Because as I prepared my remarks, I actually

found language in there that I haven't been using as a private practitioner. And I'll warn the agencies that I may start doing so.

(Slide.)

It's up. I'll read it for those of you who believe in an oral tradition. Paragraph three says:

> The Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies. Only alternatives that are practical in the business situation faced by the merging firms will be considered in making this determination; the Agency will not insist upon a less restrictive alternative that is merely theoretical.

And if you just take a look at this first sentence, it seems to me, just doing a little bit of jurisprudence on the first sentence, there are really two elements. One is that the efficiency that we're going to talk about in Section four is caused by the merger. So I would call that "merger-caused efficiencies".

But there appears to be a subset of

efficiencies that are merger-intrinsic or not merger-intrinsic. In other words, if the efficiency is not unique to the merger, we'll ignore it. And I think it's in that sense that most of the time when people say with the back of the hand, well your efficiencies are not merger-specific, you could go buy another company and get the same purchasing efficiencies. And it's that element that I think has devolved into a violation of the last sentence, which is that the agency will not insist on a less restrictive alternative that is merely theoretical.

In my experience in the last seven years, oftentimes people in a conference room will posit a theoretical alternative and no one will debate whether it's practical or not, or whether the managements could ever really go there, or the time difference between abandoning this merger and the time cost of trying to do something else. For instance, in a merger people will say do a production joint venture, and there are a lot of reasons for why a 50-50 production joint venture starting today from the time that we're talking in the conference room, could be three to five years away from realizing a fraction of the same synergies and cost savings that a merger can efficiently realize maybe in a matter of months or weeks, depending on the closing date.

So there's a distinction that I draw on in the

paper between merger-caused efficiencies and merger-intrinsic efficiencies. And just so I'm provocative and hopefully clear, I reject the merger-intrinsic concept. I don't see it as necessarily a useful concept, because I think in practice, what happens is, you wind up battling against theoretical alternatives, and that that last sentence in the Guidlines, which is a good, laudable sentence in practice has not materialized in the conference rooms at either agency.

It's also interesting to me that the sentence that reads, “only alternatives that are practical in the business situation faced by the merging parties.” That phrase has not been quoted by any of the cases decided since 1997 that have dealt with efficiencies. The courts don't discuss it, and there is no clear allocation of who's got the burden.

In other words, if the merging parties can demonstrate likely efficiencies, shouldn't the agency have to say there exists a practical alternative, and it's X, and actually produce some evidence about a practical alternative? But that's not what's done today.

Now where did we get this notion of a less restrictive alternative? It's imported from joint venture law where we're trying to figure out what restraints are reasonable. But the courts in joint

venture law, in a decision that I like very much, the American Motor Inns case, have really discredited the notion of trying to find the least restrictive alternative, and I go through that in the paper.

I think that the problem with the way merger specificity gets interpreted today in the conference room of the agencies is that it really does devolve into, well, that's just not merger-specific. And it's a back-of-the-hand kind of statement rather than a real debate over any practical alternative that someone would propose.

Let me turn to, I think, what is the typical back-of-the-hand speculation, which is why don’t you do a production joint venture? And probably any of the panelists that have worked in the private sector with parties that have done 50-50 joint ventures could probably tell you, maybe but for the attorney-client privilege, about the horror stories of trying to advise clients on 50-50 joint ventures. And I'll just try to highlight what I think in general led to the skepticism of them.

I think the first is, typically joint ventures that are set up 50-50 between two competitors have the problem of being orphans. Because there's a 50-50 split of the management of the joint venture, the joint venture

is really an orphan. It's not really owned or dominated by one firm. They wind up having, at least in my experience, they have these large meetings that really become management-by-committee, rather than a straight linear model. That may seem trivial, and we might all conceive of, well, they could come up with all kinds of tie-breaking mechanisms, but in the real world, that's an issue.

The second is, I think, the formation of 50-50 joint ventures takes two, three, four times what it takes to put together a merger. Mergers in general are very simple, very direct, very linear. I own you. That's it. I know there are complications. I know sometimes the target actually takes over the acquirer in the long run, but in general, they don't suffer from the lack of a pyramidal structure. And third, in a joint venture, both of the parties to the joint venture are over time going to have to contribute intellectual capital and real capital to the joint venture. And there tends to be a reluctance to do that if it's a 50-50 joint venture.

Now I'm mindful that you could have a 60-40 joint venture and other ways that might somehow get around this, but I think that those are real world issues. Sitting in the conference room at one of the agencies, oftentimes the time difference between the

merger that you have today, the bird in the hand, versus two in the bush, can be quite extreme.

Now one thing that I will fault the merging parties and their lawyers for is, I don't think we make good enough use of the Guidelines' 1997 language about timing, and we've got that on the next slide.

Just the next page, David.

(Slide.)

Footnote 35 says "If a merger affects not whether but only when an efficiency would be achieved, only the timing advantage is a merger-specific efficiency."

I think most of the time, practitioners and the staffs at the agencies trying to build a case only see the word "only" and they kind of blow by the fact that the 1997 revision at least acknowledges the very important element of time, and I think it relates to a lot of what Joe Simons was saying earlier.

There are huge timing advantages, maybe of two, three and four years, and those time advantages can add up to in some mergers tens of millions or hundreds of millions of dollars in difference between cost savings between different practical alternatives.

I'll also credit the current Commission for the Novazyme decision, which is a recent decision where

Chairman Muris in his statement made a very good and reasoned decision of LRA analysis, Less Restrictive Alternative analysis, and stressed the efficiencies that were the bird in the hand rather than going for two in the bush.

I would like to talk briefly about some of the decisional case law, only some of which I have the scars from. I will, simply because Chairman Pitofsky is here, talk a minute about Staples. Staples is a good illustration of a really flat out war between the merging parties and the agency with the judge giving us the benefit of his courtroom for a week. It was really a wonderful thing.

And Staples probably had one of the biggest battles over efficiency. I think there really were serious efficiencies, and the staffs that I've talked to over the last seven years -- I can't believe it's been seven years since Staples -- have acknowledged that the efficiency arguments in Staples were very serious, very compelling and kept people up late at night. And in fact, the 1997 Guidelines came out during some of the agency consideration of Staples.

One thing I would point out, and again, maybe the fault comes back to me for not focusing on footnote 35, one of the arguments that appears in Judge Hogan's

opinion is, well, Staples and Office Depot are going to continue to grow organically, and the agencies told us in their deliberations, well, Staples will double over the next seven years.

But the argument we made, but we didn't make it forcefully enough for Judge Hogan, is, yeah, but you get the merger efficiencies today. You don't have to wait seven years. And seven years times these numbers add up to very, very large numbers. And it's interesting. We probably should have beaten more on footnote 35. I think we were just shocked that Guidelines that came out in April would be used by a judge in June. But that was one of the learning experiences of Staples.

Staples is an important decision on efficiencies simply because it really, I think, creates the modern era where efficiencies are serious. I think that's one of the good things from the 1997 Guidelines, is the agencies are really taking on efficiencies and saying, at least in the text of the Guidelines, they're important, and certain efficiencies we'll credit.

My criticism is that we're putting the efficiencies through too much of an obstacle course and not comparing the likely post-merger world with the likely world without the merger.

Tenet Health is another case where the case was

reversed on efficiencies. The other case that I talk about in the paper, and I'll let you read the paper, is I have a brief discussion of the Heinz baby food decision. I think it's quite possible that this case ultimately will live in antitrust infamy, maybe much more so than any other case that I've seen.

The production efficiencies were quite considerable. The competitive effects, I think, might have been very questionable. I will hasten to add, I reviewed none of the evidence. I wasn't the decision maker, so I won't put myself in the shoes of the decision maker. But just analyzing the D.C. Circuit's opinion, it seems that the Circuit opinion is very cavalier about the efficiencies. And, for instance, a 22.3 percent efficiency improvement in total variable manufacturing cost, which would be stunning, is considered a triviality. I think, to any business executive, the notion that you could have a 2,200 basis point improvement in manufacturing efficiency, and that that would just be cast aside as, well, that's not that significant, or that's not merger-specific, you can do something else is stunning.

There's another passage on distribution and logistics where the point is made by the court, well, Heinz has very efficient distribution. Why can't Beech-

Nut have very efficient distribution? But there's no evidence produced by the opponents of the merger as to what practical steps could have been done Beech-Nut to improve the efficiency. And I think that the onus should have been on the staff and on the Commission to do that.

And there have been decisions that have been very favorable to what I call merger-caused efficiencies. I'll let you read those in the paper. University Health, which predates the 1997 Guidelines revisions. Butterworth, and a 1990 case with the DOJ, the Country Lake Foods case.

In those decisions, what I liked from those decisions is that the court really seems to get down to the bottom line, just the effect of the merger versus the nonmerger world, rather than using hypothetical alternatives in a less restrictive alternative way, which is, I think, what the phrase "merger-specific" has devolved into.

Now where do we go from here? It seems to me that where we are today is that we really are doing less restrictive alternative analysis even though we say that we're not. Really, in the conference rooms, it can sometimes work that if somebody postulates a theoretical alternative, that's really the end of the discussion, or at least the end of the discussion that you experience.

A couple of practical things that I would do. First, I think that I would put the onus on the staff to come up with practical alternatives. There are investment bankers out there. There are management and business gurus out there. If there really is such a solid, practical alternative, let's get testimony about it. Let's test that hypothesis with actual evidence. That has not occurred in any merger case that I've been involved in, and certainly not in any merger trial that I've seen.

I think second, ultimately we are going to in the next revision of the Guidelines or the next step in the evolution of considering efficiencies, I think we'll move more away from whether or not an efficiency is merger-intrinsic, and we'll really look at whether the merger causes the efficiency, and we'll especially look for whether that merger-caused efficiency feeds back into competitive effects.

The net assessment of the merger comes in Section two, and those efficiencies that directly improve competitives and rivalry in the industry should already be considered today in the Section two analysis.

Let me just conclude with a couple of where we go from here observations. I think the first is, we private practitioners who are on the outside, I think

need to push efficiencies. I think it's a very well taken criticism that the treatment in the conference rooms of efficiencies has led attorneys to focus much less on the real world efficiencies and synergies and styles of management.

I think a second observation I would have is, that our economy continues to move to a service and virtual economy. Even the companies that sell products like Dell, really are virtual companies. They acquire and really excel at production logistics and distribution rather than physical manufacture of products. And I think that has certain implications for merger-specificity.

For instance, the 1997 Guidelines take a dim view of certain logistics and purchasing synergies. I think that's unwarranted in today's economy. In an economy that's dominated by firms like Wal-Mart, I think the Wal-Marts of the world need to be challenged by smaller firms that may actually get themselves larger by combining.

And so those are some of my observations, and I leave to you my paper and Voltaire and Spinoza.

MR. ABBOTT: Okay. Thank you for that literary and philosophical set of insights, Mark. And now we're going from literary and philosophical approach to a very,

very meaty paper by Ilene Gotts. I've been going through her slides. And she's going to give us insight on a number of issues raised by Section four of the guidelines. Her slides are entitled "The Role of Efficiencies in Integrated Merger Analysis." And although there's a lot to be covered, as Ilene was reminding me, she's a New Yorker, and she can talk fast. Ilene?

MS. GOTTS: And I'm going to trust Dave with my slides. We're going to test his technical capabilities here.

I will handle this very fast. And there's also a paper that I worked on. One of the advantages of the business downturn last year was it allowed me to take some time to read some of the legal, economic and business literature that was out there to get a sense on how the rest of the world is viewing efficiencies and then I compared it a little bit to the Merger Guidelines.

The Merger Guidelines state that certain types of efficiencies are more likely to be cognizable and substantial than others. There's a real clear bias towards production efficiencies, that these are thought to be cognizable and substantial.

Innovation efficiencies are thought to be substantial, but less verifiable. And when you get into

things like procurement, management and capital cost efficiencies, these are thought to be less likely to be merger-specific or substantial, which as you'll see as I go through this, is almost directly opposite the business literature that's out there.

When you look at why deals are announced, they're very much in this last category of procurement, management and capital cost efficiencies. And indeed, some of the presumptions that we build in throughout to be skeptical about these efficiencies seem to be contrary to the obligations that directors and management have under Sarbanes-Oxley. If anything, they have to be very careful about what they publicly announce as efficiencies, because if they're wrong at the end of the day, they lose their jobs. They have shareholder suits. They have the other liability and problems.

So, you know, that's just the backdrop from which I come from as I look at this.

What kind of efficiencies should be recognized? Although the agencies might have more experience dealing with certain types of efficiencies, such as when we look at productive efficiencies, other types of efficiencies should not be excluded or handicapped on a generic basis.

And I think some of what we've seen develop in our understanding has actually come to fruition when you

look at the EU Guidelines, which don't seem to draw as much of a distinction -- we'll probably hear a little bit more about this from Vincent -- in that it says that you consider any substantiated efficiency claim in the overall analysis of the merger.

Productive efficiencies, as we said, are the least controversial. One aspect that remains controversial is, I think it should include fixed costs, not just variable cost. Because at some point in time, especially when you start talking about distressed industries where the whole industry is not producing well, these efficiencies are very important. They can have an effect by just increasing cashflow, making it more possible to get significant nonprice benefits to consumers, such as to fund innovation.

And in marketplaces that are changing, either they're distressed and you need to realize it, or where market definition is changing, convergence markets, high technology markets, these fixed cost savings are just critical to the bottom line and to whether or not the great new products of the future will be realized.

Also, distribution and promotional efficiencies. The 1997 revisions are silent on these. The global staff report, which is 1995 -- which is wonderful to read, by the way. It is just full of

information -- unfortunately find that these types of efficiencies are less likely to be substantial and often likely to be difficult to assess.

Just because distribution and promotional efficiencies are less likely to be substantial and might be hard to assess doesn't mean that they don't count. We should try to, wherever we can, to factor it in.

Dave mentioned that when you look at the quirkier remedies -- I think that would be the way I would phrase what you were saying, and hopefully I'm not mischaracterizing it -- when they carve out various things that are novel, that's because there's been an effort to save efficiencies.

I would make one other note about when I look at remedies. When I've been in here on Nestle/Dryers or what I've seen from Exxon/Mobil or even in the General Mills/Pillsbury thing, I have found that the staff is thinking about distributional efficiencies in what they're demanding I'd make sure is in the divestiture package. So if it's something that I have to put in, and in that case they think it's for real, why isn't it for real when as a merger party I assert it? To me, we should be consistent in the approach we take and we should recognize these.

Dynamic or innovative efficiencies. The 1997

revisions indicate that claims relating to research and development are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions. The global report also acknowledges that they may be -- innovation efficiencies may make a particularly powerful contribution to competitive dynamics.

At the same time, when you come in, you get hit over the head by the staff saying verify them. We should consider dynamic efficiencies in the integrated merger analysis, as Joe has noted in his talk, he's tried to factor it in. These are harder to quantify. We're not talking about mathematical precision in any of what we do. But you can build on whatever assumptions you want, a range of assumptions, and in your gut get a sense whether they're for real or not, whether they're powerful, and whether they're something we should therefore use to allow the deal to go through.

Transactional efficiencies, the elimination of the middleman and the double marginalization. These are important. These are really bottom line numbers which then can flow through and allow for there to be new products to be offered. And, therefore, they should definitely be included in the integrated merger analysis.

And then my favorite area, which is the

procurement management and capital costs. 1997 revisions are very, very resistant to recognizing these. And yet, in every deal I've had just about, procurement savings, reducing the number of suppliers, going to best practices, coming up with a way to reduce costs are always a factor for why businesspeople are doing a deal.

Managerial savings. The merger specificity part of this. The reality is, it is very hard when you have an entrenched management because of not only the fact that they're there, but because of labor law, because of tax law, to just say you're out. A merger provides a perfect excuse for doing what you might otherwise want to do. And, therefore, we shouldn't tilt it and say we're not going to recognize it.

Capital cost savings. The G.E./Honeywell decision from what I can see in the EU seems to view this as a negative. The reality is, again, this can make a huge difference if you can somehow improve the balance sheet a larger amount and borrow money at a lesser amount, if you've got an industry that's going through change or is distressed, these are very important to the ongoing competitiveness of the company and should not be at all thrown out as not recognized.

This gets me then to what burden of proof should be imposed upon the parties. Let's look quickly

at what is currently the case. When you look at the Merger Guidelines and the case law, you see efficiency claims will not be considered if they are vague or speculative or otherwise cannot be verified by reasonable means.

You see statements in there about a sliding scale that Dave was mentioning. The greater the concentration or the greater the concerns of more burden that's put on the parties.

As Joe noted, and this is very important, we're making guesses as well for market definitions and other things. I don't quite understand why once you make a guess or put a probability on one side it becomes the case. It's per se. It's presumptive. And then all of the burden shifts.

When we look at concentration analysis, there's a lot now in the literature to suggest that there aren't these bright lines in the rules. It depends on the industry as far as when the concentration is too much and how competitive it's really operating. So again, putting huge presumptions on parties and tilting the sliding scale, changing the playing field on the basis on these sorts of things, suggests a precision with respect to the anticompetitive effects that is unfair and can lead to really bad Type II decisions.

The case law. Heinz is going to be great. We might have lost the battle, but we might win the war because of that case. That is a bad case. As I understand it, Heinz now is pretty much -- one of the companies is not in the business. The anticompetitive effect we thought of didn't happen because, you know, of the fact that the merger didn't go through. But, the company doesn't exist anymore. And to have imposed such a huge burden and thrown out of consideration huge, substantial efficiencies just was wrong.

When we look at the EU Guidelines, again, we see some learning in many areas, but we still see this tendency to say that efficiencies must be substantial enough to counteract a merger's potential harm. And again, this suggests that there's some precision mathematically that I don't think exists. I think Joe's model goes a long way in helping us to start thinking about how you look at this, and especially in building in the probabilities, but the math is not there.

So I would really suggest as a result that we really step back and we really stop putting in so many presumptions and tilting the balance so strongly and maybe look at this like we do in other areas, like Section I. Initially you start out where the plaintiff has to show there's some possibility of an

anticompetitive harm. Then the parties have to show there's some legitimate purpose for it, i.e., like efficiencies, and then it shifts back to the plaintiff again to show why that's not the case.

Per se rules and presumptions built in where they can't come back is just really wrong.

To save some time, I would like to skip up to slide 12, if you wouldn't mind, Dave.

(Slide.)

And basically remind everyone that when we're talking about Clayton Section 7, we're talking about probabilities, not possibilities, and that's really what the standard should be here, and that when we look at this, the other problem I have is, I find the agencies are wonderful. You can come in and you can talk to them about efficiencies, and in close cases, I think they go the right way. Their gut says, okay, this is a deal we shouldn't block.

But when they go to court, it's like all bars are off. The agency all of a sudden goes back to Brown Shoe and Vons or anything else they can dig up with these horrible presumptions to concentration, because they're out to win the case.

And when you look at what the role of an agency is, I love this seminal case, the Berger v. United States

Government. The government is supposed to govern impartially. Criminal prosecution is not that it shall win a case but that justice shall be done. And to me, justice is not done by going to a bunch of legalistic presumptions and tilting the case so that Type II errors are made, but by applying the same standards at the agency and then going forth to the court with the exact same standards and letting a judge weighing the evidence and decide where the probabilities really stand.

When we weigh efficiencies effects in declining industries, this is what I'm up at night thinking about these days, because I really do want to try to get it right. To me, there are certain things in the Guidelines today that seem to recognize that declining industries, these are industries where the price is really below average total cost. So we're basically -- price might be covering the variable costs, but no one is investing in the future. This is an industry that is going to be really declining and dead for a long time.

In my heart, there's some need in that sort of market to look at being more receptive to arguments about potential dynamic or innovation efficiencies, to really be more willing to accept the fixed cost sort of arguments, because the end of it all is, yeah, maybe in the short term you might be limiting some competition

that is there, but in the long term, the potential harm to the industry from ignoring two efficiencies and whether consumers actually benefit consumers from efficiencies being realized by new products being transitioned is really great.

So I would really like to see something more explicit in the Guidelines to recognize declining industries and how we might look at it. I'm not at the stage where I even feel I could draft what that should be, but something should be done on this.

In conclusion, I think the Guidelines should clarify that the competition authorities will consider all types of efficiencies as long as they are verifiable, substantial and likely to be realized. We should stop this idea that some count more than others.

Efficiencies should be subject to the same standard of proof, and that should be as clear as evidence relating to a likelihood of anticompetitive effects, both during the agency review and then in the court challenge. Then finally, that when considering a merger in a failing industry that we'll be even more receptive and we'll give more weight to potential dynamic or innovation efficiencies that could help to sustain the industry or to transition it into the new products and services that it needs to offer.

I stayed within my time.

MR. ABBOTT: Thank you, Ilene. You certainly did, and very provocative remarks. And you hit a lot of topics. And now I'm pleased to turn to Bill Kolasky, who I know has given speeches and written on efficiencies, and I'm particularly interested in hearing what he might have to say about how lessening of competition in one market might be justified by efficiencies in other markets, sort of another aspect of Section IV of the guidelines that perhaps has not received all that much attention, at least until Bill started to emphasize it.

Bill?

MR. KOLASKY: Thank you very much, Alden. I'm going to focus on three main issues. The first one is what is a cognizable efficiency? The second is, to what extent should "fixed cost" -- and I put that in quotation marks -- savings that do not reduce marginal costs be taken into account? And then the final subject is the one that Alden alluded to, and that is, to what extent should efficiencies in other markets be found to justify a merger that reduces competition in a particular market?

In my comments, I want to make it clear that I'm not offering fully formed views, much less recommendations. What I'm trying to do is stimulate some discussion and debate.

I'm going to start out by turning the criticism not on the agencies but on us practitioners. Based on my year and a half at the Justice Department, I think it's fair to say that there is more serious and critical thinking going on within the agencies about the role of efficiencies in merger analysis than there is in the bar at large.

I think one of the problems is that the agencies do not hear enough well thought out and well presented efficiencies arguments. So to the extent that they can be criticized for not taking efficiencies sufficiently in account in their merger review, the fault lies in us, the practitioner, not in the agencies. And I'm hoping my remarks will start us down the road of trying to address that problem.

Focusing first on what is a cognizable efficiency? While I think that the basic analytical framework in the 1997 revisions is sound, as Ilene's summary of it, I think, reflects, that framework is to some extent mired in the old economy, smoke stack industry paradigm, and I think our thinking about efficiencies is likewise mired in that paradigm. We try to put them cubbyholes like productive efficiencies, innovative efficiencies, procurement, management, purchasing. As a very good article, in fact,

one of the best articles on efficiencies that I think has appeared, by Joe Farrell and Carl Shapiro in the Antitrust Law Journal shows, the most important efficiencies are not production cost savings and other forms of cost savings, but rather the synergies that come from combining complementary assets, complementary strengths.

To some extent, you may be able to quantify those efficiencies, but often you are not able to quantify them, and you have to evaluate them more qualitatively.

Let me take four or five cases that I've been involved in to illustrate what I mean and why I think we need to change our thinking about this.

The first one, interestingly, was a case way back in 1983, shortly after Bill Baxter took over as head of the Antitrust Division, involving two companies that make rechargeable nickel cadmium batteries. Interestingly, the market structure in that case was virtually identical to the market structure in the baby food merger case. You had one dominant supplier, G.E., with about a 65 percent share. You had a second company with about a 20 percent share, and you had a new entrant with maybe between a 3 and 5 percent share, which was a foreign manufacturer, and then you had a declining, you know, fourth company that clearly was not going to be in

the business very long.

We hired George Stigler to work with us on this merger, and with Stigler's help, we persuaded Bill Baxter to allow a merger of the foreign producer, and it was the leading producer in the world of these rechargeable batteries, to merge with the number two company in the United States.

The efficiencies that we saw from that deal had little to do with production cost savings, but were simply that the foreign producer had the best technology and this number two company in the United States had a well established distribution network in the United States, so that the combined firm would be able to go head-to-head with the leading producer, G.E., much more effectively than either firm could do separately.

A second case, interestingly the same vintage, 1979, was the Ford/Mazda merger. This was a case where Ford bought a 35 percent interest in the Japanese company that makes Mazda. Working with us on that merger were Don Turner and Oliver Williamson.

The reason for that merger was that Ford was moving toward front wheel drive cars, had very little experience making those cars, and it was acquiring the transaxle for those vehicles from Mazda. And it was very concerned about the possibility of opportunistic behavior on

Mazda's part. So they wanted an equity stake in Mazda to protect themselves from that opportunistic behavior.

In addition, that was an era when the Japanese car manufacturers had more modern management techniques than the U.S. companies, and Ford believed, and I think correctly, that the only way the Japanese manufacturers would share that knowledge with them is if they were going to benefit from sharing that knowledge because of this equity relationship. Again, these are not things that are easy to quantify, but the illustrate the importance of synergies from combining complementary assets.

Fast forwarding to the late 1990s, a merger that was reviewed by the Justice Department under Joel Klein and was approved was the merger of the Fox and ABC affiliates in Columbus, Ohio. This was a four to three merger. The Justice Department had never before allowed a four to three merger in the television industry. Why did they allow this merger? Well, one of the principal reasons was that we were able to persuade them that it would provide an incentive to the companies to do more complementary programming. Rather than having two Survivor type shows going head to head, competing for the same audience, which is what they would do as long as they were independent, if they were commonly owned, they

would have one Survivor type show and a new show, and together, that would actually increase output and allow them to sell more advertising. But they wouldn't have the incentive to do that kind of complementary program unless they were commonly owned.

And in the final case which came out the other way is the Direct TV/Echo Star merger which was reviewed by Justice about a year ago. There too the efficiency argument that was being made by the parties had nothing to do with cost savings. It was that the combination of these two direct broadcast satellite companies would allow them to offer local into local program, which neither of them would have sufficient channel capacity to do independently.

The reason the Justice Department rejected that efficiency was because they ultimately found that it was not merger-specific, that because of advances in technology, there would be sufficient channel capacity within the next two years to offer local into local program without the merger, and that is in fact what has happened.

The Heinz/Beech-Nut case, I agree with all the negative things that have been said about that decision, is probably going to become the Procter & Gamble/Clorox of our generation. And it's a good case that illustrates

the importance of integrating efficiencies into your competitive effects analysis.

At bottom, the reason the D.C. Circuit found that merger unlawful was because they viewed it as a three to two merger that was likely to lead to a greater coordination and higher prices. They pushed aside very significant efficiencies, and again, there weren't just the production cost savings that Mark referred to, but there was also the importance of being able to combine the strong Beech-Nut brand with the lower Heinz production cost in order to compete more effectively against the dominant Gerber.

The facts of that case in fact show that you already had coordinated pricing going on, but there was the leader-follower pricing, and Gerber basically was able to price at a high level under the umbrella created by the fact that its rivals were so much higher cost producers. (AUDIO GAP) merger, because the rival would have costs comparable to Gerber, there was every reason to believe that even if they continued to coordinate as they had been, prices would be lower, and consumers would be better off. The D.C. Circuit never even thought about that issue, or at least if they did, they didn't write about it.

Let me move on quickly, because I have a

limited amount of time, to my second issue. But I hope what I've illustrated by this is that we need to get away from thinking about efficiencies just in terms of cost savings. Think about them principally in terms of combining complementary assets and whether that is going to allow the merged firm to produce a higher quality product and/or increase its output. Let's get away from thinking just in terms of price and cost.

The second issue is how much weight should be given to fixed-cost savings. And here the text that I begin with is footnote 37 to the Merger Guidelines, which provides that while savings in marginal costs will receive the greatest weight, the agencies will also, quote, "consider the effects of cognizable efficiencies that have no short-term direct effect on prices in the relevant market," such as fixed cost savings. Again, the way that footnote is written, and that entire section of the Guidelines, suffers from this problem of the old smoke stack industry paradigm and sort of a static price theory model. As soon as you move away from that model to a more dynamic view of competitive forces, you recognize that in fact cost savings and other efficiencies that do not reduce marginal costs nevertheless are likely to benefit consumers not just in the long term but even in the medium and short term.

A good book, I think, on this subject is William Baumol's book, The Free Market Innovation Machine. And based on the arguments in that book, I've tried to extend this argument in an article that's going to be published shortly in the Antitrust Bulletin entitled "What is Competition? A Comparison of U.S. and European Perspectives." And what that all shows basically building on the intuitions of Joseph Schumpeter is that in most new economy industries, competitive behavior is driven primarily by innovation, not by cost. And where that's the case, firms need to incur basically recurring R&D expenditures. They need to invest in improving and innovating in order to remain competitive. That creates what Baumol calls a "Red Queen Game" in which the firm needs to run as fast as it can just to stand still.

In these markets, not surprisingly, you find very high price/cost margins, and that's because the firms are investing heavily, and they need to be able to charge prices above marginal costs in order to recoup that investment, in order to justify it.

Nevertheless, these are industries in which innovation is rapid, and in fact price is often falling over time, even as price cost margins remain high. Baumol suggests, perhaps not surprisingly, since he created it along with

Bobby Willig, that the model, the economic model that should be used for evaluating competition in these industries is not the traditional price theory model, but rather the contestability model. Because what he argues basically is that what determines price in these industries is the level at which prices will attract new entry, and firms, even though they charge prices that are above marginal costs, nevertheless do not have any market power because their prices are constrained by the threat of entry, and because they are earning only a minimal return on capital, i.e., on their investment.

In these industries, obviously, efficiencies that help to reduce the cost of R&D and other recurring common costs will help to drive down price over time and lead to greater innovation and improved products, i.e., dynamic efficiencies, and those need to be taken into account.

Finally, and I apologize for rushing, but there is a lot to cover here, and I want to make sure to save time for the discussion, to what extent can a lessening of competition in one market be justified by efficiencies in other markets?

Joe, I think, referred to the fact that back in 1982, everyone was skeptical as to whether the hypothetical monopolist approach to market definition

would work. Obviously, we've gained a great deal of experience with that approach over the last 20 years. I think as a practitioner, that one of the things that has been most striking to me over the last five to seven years is that as we have applied the hypothetical monopolist market definition test more rigorously, markets have come to be defined more and more narrowly.

Second, as we've moved away from homogeneous commodity-type products, more and more markets are characterized by price discrimination. And in markets characterized by price discrimination, you could, as a theoretical matter, define virtually each customer as a separate market. And in fact, at the Justice Department at least, when they analyze mergers, that is in fact how they look at them as they try to evaluate the likely price effects of a merger.

They may not define the market that way when they go to court. I think that's Ilene's point. But even then, the market definitions are much narrower today than they were a generation ago. Look, for example, at the Justice Department's complaint in the First Data/Concord merger case where they defined the relevant market as "processing PIN-debit cards at point-of-sale." And certainly in the similarly narrow market definition in the merger case where Mark was successful in beating

back a challenge, because the judge simply didn't understand what role price discrimination plays in defining the relevant market.

As we move to increasingly narrow market definitions, it becomes more and more important that the agencies take into account out-of-market efficiencies. Andrew Dick and I have written an article that appeared this past year in the Antitrust Law Journal and we describe a particular merger case that was reviewed by the FTC while Bob was there, which I think is a perfect illustration of how important this is. That was a merger involving two natural gas gathering and processing systems in West Texas, right next door to George Bush's hometown of Midland. That was an area in which production -- the fields were very mature. Production was declining. The processing plants were running at less than 50 percent of capacity, as a result of which unit costs were rising sharply. There were very few wells in this area that were close enough to both gathering systems to benefit from competition between them. The remaining customers were gathering systems or processing plants in these two counties. So this was in one sense a merger-to- monopoly. And yet, when the FTC staff understood that there were literally only a handful of wells, maybe a dozen or so, that benefitted from the

competition between these two systems, whereas there were hundreds of wells that were going to benefit from the cost savings resulting from consolidating the two systems, they granted early termination of the second waiting period.

The efficiencies were outside the relevant market in which the anticompetitive effect would be felt, and yet nevertheless, they were recognized as swamping the potential anticompetitive effects, so the merger-to-monopoly was allowed.

Another very good example of this, but a more controversial one, is the Surface Transportation Board's decision in the Union Pacific/Southern Pacific merger case where I was one of the opponents. There, there were a large number of routes from the Gulf Coast to the Chicago-St. Louis area that were basically two -- or the merger was a two to one merger. It was a merger-to-monopoly. The Surface Transportation Board was convinced, however, that there were very substantial efficiencies from combining the networks of the Southern Pacific and Union Pacific roads that would benefit all of their shippers on all of their lines. And, therefore, in order to remedy the anticompetitive problem, rather than ordering divestitures, they structured a trackage rights remedy that would give a third carrier the rights to use

the UPSP tracks to service these customers. And I think that's a good illustration of how efficiencies factor into the choice of remedy.

But, again, the point I'm making here is that that was a case where the agency found that the out-of-market efficiencies were inextricably intertwined with the negative competitive effects, and therefore tried to structure a remedy that would fix the competitive problem without sacrificing the efficiencies.

I think one of the things that concerns me about the new EU draft -- EU Notice on Horizontal Mergers -- it's now final -- is that, at least as I read it, the European Commission does not have the same flexibility that our agencies have to take into account those out-of-market efficiencies. And I'd be very interested to hear from Vincent on how the Commission would deal with cases like the two that I've just discussed.

Thank you.

MR. ABBOTT: Thank you, Bill. Some more provocative remarks. And now I turn for a magisterial overview to Chairman Pitofsky, who was around when Section IV of the 97 -- Section IV of the Guidelines was revised in 1997 to give us the current treatment of efficiencies.

Chairman Pitofsky was also around, of course,

for the Staples case and the Heinz/Beech-Nut case, which a number of practitioners here have trashed. And I'm sure that Chairman and Professor and Dean Pitofsky will give us a magisterial overview and maybe some rebuttal as well. Bob?

MR. PITOFSKY: Thank you. It's good to be back here in this unfamiliar but familiar FTC. This building is unfamiliar.

You know, magisterial oversight is a little different. I thought what we were going to have is that we have three or four speakers on one side saying the Merger Guidelines should be expanded, two or three speakers saying they should be left where they are or contracted, and then I would stake out a middle ground.

That's not it. Everybody who's spoken so far has said the Merger Guidelines -- the efficiency defense in the Merger Guidelines should be expanded, even made primary.

It's interesting. Historically, it was Bork, Posner and Baxter who felt so strongly that the efficiencies defense was a wrong idea. And you would think they'd have some influence today, but not on this issue. And it was Areeda, Turner, Broadly, Muris, who does have efficiency credentials, and shyly, myself, who wrote that an efficiency defense has to be included in

the Merger Guidelines. And it was the Clinton enforcers who introduced it formally into the statute.

Let me just say a few general things and then some specific things about the cases that were brought up. There is a general thread here that the conditions that are imposed to successfully assert an efficiency defense are too narrow.

Let me start at a different place. It is not my intention to defend every word and every concept in these efficiency guidelines. I heard a couple of things: Ilene's notion that declining industry aspects should be brought into your consideration of efficiencies. Absolutely. I think that's a good idea. Bill's thought that fixed and variable are unnecessarily, treated unnecessarily differently from the point of view of the Guidelines, I agree with that. Businesspeople don't make the kind of distinction that theoretical economic analysis does. And Bill's suggestion, I just want to associate myself with him, that the staff does listen to efficiency claims. The idea that they're only there to debunk the claim, that's not the agency I was at. They are there and they work hard on these things.

All right. Narrow conditions. It is true, the conditions are narrow. The efficiency must be substantial, merger-specific, timely, clear and

convincing evidence, can't reduce output, et cetera, et cetera, but that's what was intended. The idea is that in a close case, efficiencies can be a tiebreaker. The idea was not that efficiencies ordinarily will allow you to merge three to two, or two to one. That's not what American antitrust is about. That's not what this statute, which says "tend to create a monopoly" is about.

On producer surplus, I'm sort of agnostic. If the producer surplus were enormous and the anticompetitive effect were tiny, I guess anybody would take it into account as a matter of prosecutorial discretion. I'm pretty sure you would do that.

As to some of the proposals, exceptional effort, thoughtful, creative. My question is going to be, Joe Simons and others, can we do it? And you make a very fair point. A lot of people said that about the definition of relevant market. And now we've learned how to do it, and we can.

But I'm worried about this one. Antitrust is a practical enterprise. It's not the development of a dissertation. And I just keep thinking to myself -- well, let me take as an example, the claim is that, yes, the merger will lead to higher prices now, but down the road, three years, four years, five years, the efficiency will produce lower unit costs and perhaps, maybe even

probably, lower prices. And I keep wondering, what will the subpoena look like that tries to get at the question of whether or not five years down the road there will be lower prices, that the efficiencies will kick in.

Look at how many times people have claimed efficiencies and they never kicked in. What are you going to do with the company five years later when it turns out that prices are still higher and the efficiencies haven't kicked in. You can't break up the company, not if it's a horizontal merger. So there are practical problems here.

There are also technical problems. It's contrary to the statute, which says in any line of commerce. It's contrary to the spirit of the Guidelines, and it produces the odd situation where one set of consumers who buy today are financing lower prices for another set of consumers who buy later. But my main concern is, could you possibly do it?

Let me raise a question for all of you. Do you believe in British Oxygen? Do you believe the court when it said that it will not let the plaintiff get away with coming in and making the anticompetitive case in some speculative way? Well, judge, I can't tell you that there will be an anticompetitive effect now, but I can tell you eventually there will be an anticompetitive

effect, and you ought to strike down the merger. And what was it, the 2nd Circuit? FTC. FTC got thrown out on their ear on grounds that you can't come in here with that kind of speculative talk and expect to block a merger.

I agree with that decision. I think the plaintiff has a responsibility to show clearly by convincing evidence that there will be an anticompetitive effect in a timely manner. But I think the same thing for defenses. I don't think that one should be allowed to come in and say, well, judge, I don't know about efficiencies right now. Actually, prices are going to go up now. That's what makes the merger illegal. But down the road, oh, then everybody's going to really be in great shape. A little too speculative for me.

Ilene talked about hierarchy of efficiencies and clearly said that, you know, maybe there are differences, but you shouldn't disregard certain efficiencies entirely. I would disregard certain efficiencies entirely. Let me say, the best work on this by far is about 70 or 80 pages in Areeda, in which goes through efficiency by efficiency by efficiency and talks about whether or not they should be taken into account to the extent that they reverse the result in an otherwise illegal merger.

Reduce unit cost is the clearest case. The Guidelines picked it up. The writers have picked it up. Generally speaking, you can prove it. You can know the reduced unit costs are there. The Guidelines talked about R&D efficiencies. I remember that as being quite a quarrel, because I don't think Areeda thought so highly of that. But I think R&D is so important to the welfare of the country, the economy and consumers, that R&D efficiencies should be cognizable.

But then these other efficiencies are more or less savaged by Areeda. Managerial efficiencies, promotional efficiencies, capital cost efficiencies. Let's just take managerial efficiencies. The company is being run poorly, and you should do something about it. Well, there are two possibilities. You can merge with a company that's being run well, or you can fire the bad manager, and like George Steinbrenner in New York, you can hire a better third baseman. You can pay the money to bring in a first rate leader or a consultant to a second rate leader, that sort of thing.

It seems to me that managerial efficiencies are vague, hard to measure. How do you measure what a really good CEO, president, sales manager brings to a company? What questions do you ask about that? Hard to define what a managerial efficiency is. And the tradeoff

between managerial efficiencies and anticompetitive effect is going to be hard to manage. If the prices go up, what are you saying? But this manager eventually will bring the prices down? Well then we're back to speculative and eventuality, which British Oxygen said we ought not do.

And finally, there's a less restrictive alternative. I don't think there's a shortage of capable managers in this country. And I don't think the only way to get a capable manager is to merge with your competitor or your customer or your supplier, something like that.

Let's see. Merger-to-monopoly justified by efficiency. I guess I've already said. It's not our statute. It's not our Guidelines. It's speculative. I understand that a company that expands internally can point to its own superior skill, foresight and industry. But this isn't expansion. These are mergers. And the question is whether or not you would allow a merger-to-monopoly and say, but, judge, we're so efficient. And we'll lower costs.

First of all, why would a monopolist do that? If you're a monopolist and a profit maximizer, it seems to me you wouldn't lower costs if there are high barriers to entry. If the Baumol theory is you're running hard to stay in place, the agencies should take that into

account. That's fair enough. That's fair enough.

Okay. Now, let's see. Shots at the Commission. Look, baby food you say will live in infamy. It's a tough sell and similar mild comments. It's the Procter & Gamble of the new generation.

(Laughter.)

Let's put this into context. A hundred and fifteen years, and no court has ever approved a three to two merger unless there were low barriers to entry and a failing company assertion. A hundred and fifteen years. So it was hardly a departure. Unanimous Court of Appeals affirmed what the Federal Trade Commission said.

Now since the deal, I'm not even sure what's happened, but I gather Gerber has grown and one of them has gone out of business.

Heinz sold out. They exited the market.

MR. PITOFSKY: Okay. I guess I have to think about this one. But, you know, you play the cards you're dealt with. At the time of the merger it was three to two, the two, the two smaller ones were competing with each other, fairly and vigorously, and it seemed to me the case was justifiable. And I don't recall -- and somebody may make me eat these words -- I don't recall either of the merging parties coming in and saying we're going out of business. They might say we will never be

efficient and we'll curtail our activities. I don't remember anybody saying they would go out of business.

Now, does that mean the Commission will never take a three to two, never allow a three to two? No. I think we've done it a fair number of times. I think immediately of Boeing/McDonnell Douglas where we thought it was two to two, because McDonnell Douglas such a weak player.

Chairman Muris told me that there have been several instances. It's hard sometimes to make public prosecutorial discretion decisions. But we have allowed three to two mergers. He is allowing -- his Commission is allowing three to two mergers, and efficiencies are the turning point. Efficiencies are the decisive factor.

Staples. It's been so long I forgot.

(Laughter.)

But there was clear evidence that prices went up in markets characterized by fewer superstores, and as to the efficiencies -- don't hold me to any numbers. This is very general. But my recollection is that the board of the company was told when they were thinking about a merger that the efficiencies would be X, 5X. Then when they knew they were merging, the board was told 25X. And then when they went to court, they said 75X. That hurt. That hurt in terms of trying the case.

And the other issue is much more complicated, and that is whether or not purchasing efficiencies, that is to say, you're bigger so you get better discounts from the seller, ought to be taken into account, or is that just transferring money from one businessperson's pocket to another?

I grant that that is a very complicated question.

Let me sum up by simply saying this. I think American antitrust is better off by the introduction of an efficiency defense. I was thinking last night of all the people who said you put that efficiency defense in our Guidelines and you will destroy the ability of the government to enforce the antitrust laws, because people will come in with phony efficiencies and you won't know they're phony. It will delay the matters. Cases will go on forever. It hasn't worked out that way. It hasn't worked out that way at all.

Incidentally, there was a comment that courts almost never say it's illegal, but because of the efficiencies, I'll make it -- I'll call it legal. I believe the reason for that is the agency doesn't bring cases that are barely illegal but with substantial efficiencies. And therefore, the courts haven't had a shot at this, and I'm not sure they're going to get a

shot very soon, because the agencies are very sensitive to claims of efficiency.

I think some excellent deals have gone through by emphasizing the efficiency. I think that's particularly true in the high tech R&D drug area, and the country is better off for that. And as far as global competition is concerned, the efficiency section put the spotlight where it belongs -- not on the size of the competitor, but on the efficiency, its unit cost, the quality of its product, the quality of its research. And I think for all those reasons, we're better off.

Thank you.

MR. ABBOTT: Thank you, Bob, for a very good overview and putting things in context, as you always do so well.

Finally we're going to turn to Dr. Vincent Verouden of the European Commission, DG Comp. And again, he has honored us with his presence earlier in the workshop, and he will be focusing on the treatment of efficiencies in the new European Merger Guidelines.

MR. VEROUDEN: I would like to talk about merger analysis and the role of efficiencies in the European Union.

Before going to the specific topic of efficiencies, it may be good to provide some background

on what has been going on in recent months or years in the EC merger control system.

As you may know, this merger control system, which is in place since 1990, has been the subject of a review process, a reform process you could say. And this has resulted in a new merger regulation which was adopted last month by the member states of the European Union. It will be applicable as of the 1st of May, 2004, so in three months' time.

It has also produced Horizontal Merger Guidelines which accompany this new merger regulation. So much what I'm going to tell now or today is relating to, you know, what will be the system in three months' time.

There were a couple of issues that kind of spurred this reform process. There were procedural issues, jurisdictional issues, but also substantive issues. The two main substantive issues that were being debated in this reform process were first of all, what is the scope of the existing dominance test that we have in the European Union in Article II of the EC Merger Regulation? And the second was the role of efficiencies in merger analysis, what should be the proper role of efficiency considerations in merger analysis?

Just to say a few words about the test, because

that's, of course, the main tool that we have to use in the coming years, and it's difficult to speak about efficiencies and integrated analysis without also knowing what your substantive test for review is.

And it has often been put in terms of the comparison of the dominance test versus SLC test, Substantial Lessening of Competition. Is there a difference? And the question that arose in our context with the dominance test -- by the way, I should read out what the dominance test is. It's whether a merger creates or strengthens a dominant position as a result of which effective competition would be significantly impeded. That's our current test, and it's called the dominance test.

And the question was, well, does it cover all mergers that produce anticompetitive effects? Does it deal with mergers that produce a company with significant market power, but which only is, for example, number two in the market, and, therefore, not, let's say, dominant in the usual meaning of the word?

Anyway, this resulted after, well, quite a long debate in a clarification of our test. It's now called the SIEC test. It's quite similar to the SLC test, of course, and it's also, well, normal that it's pretty similar. Namely, the test is now whether a merger leads

to a Significant Impediment to Effective Competition. So that's the tool that we will work with in the coming months -- in the coming years.

I must say, by the way, that the new test that we have, SIEC, still singles out the notion of a dominant position as a primary example of a merger that is leading to a significant impediment to effective competition.

So, well, so far for the background on this new test. Let's turn to the role of efficiencies in the EC merger control system. If we look at the past or even the current situation, if you like, with the dominance test, I think it's fair to say that efficiencies have not received much emphasis in the past.

That is quite clear. It's probably outside the scope of this workshop to really expand on this, and the reasons why and so on. I think that development in thinking that we have gone through in the European Union quite closely resembles, I think, the development that you have seen here in the United States over the course of the years where efficiencies were first viewed with quite a bit of skepticism, of course, whether they could overturn conclusions as to the anticompetitive or pro-competitive effect of a merger. So starting from there to having a more open attitude to efficiency considerations.

And -- well, I've written down here what was the conclusion of this internal reflection, well, internal and external reflection process. We really said at some point that, well, there are compelling reasons to give more explicit consideration to efficiencies in merger control. And this from the understanding, of course, that efficiencies may bring more competition to the market rather than less, if anything.

I've written a few reasons, maybe not necessary to say a lot about that. I think it's well understood. Efficiencies are a natural element, although not the easiest in any competition analysis. If you want to determine whether the merger will increase or reduce competition in the market, it's kind of hard to do that in an accurate or proper way without also looking at efficiencies or possible efficiencies.

And in this sense it's also in line with a more effects-based or call it economics-based approach to merger control.

(Slide.)

Now, the treatment of efficiencies in the new merger regulation, I think it's good to start out by saying that there was no need to change our test for the sole purpose of looking at efficiencies. Actually, given the reasons in the small bullet points down there, first

of all, we were always of the opinion that the existing test in Article II of the merger regulation, even though it had, you know, the dominance wording and so on, was a pure competition test.

And so the moment you say that, yes, efficiencies must be considered in merger analysis, well, actually, they should be part of an integrated competition analysis. So there was no real need to kind of have a separate sentence in Article II on efficiencies.

I must say, by the way, that Article II comprises a number of paragraphs, and so paragraph two and three have this test that I just said. Paragraph one of this article actually says all the factors that we have to look at when looking at the likely impact of mergers, and so it refers to entry barriers and buyer power and so on, but also to the technical and economic progress that is likely to be achieved through the merger, provided it is to the consumer's advantage. And that is wording that has been in the test in Article II since the very beginning. It hasn't received much emphasis, as I said before. But we still believe that this is a sufficiently worded text for Article II.

And, however, to signal the change in emphasis a little bit, I think there are two things that I can

say. First, the new wording that we have that actually focuses on, you know, whether there will be a significant impediment to effective competition and does not put that much emphasis anymore on the dominance aspect, probably better allows for, you know, a proper inclusion of efficiencies.

It better expresses that our test is an effects-based competition test so that instead of looking in an almost static way to whether post-merger the new entity will have a dominant position, which is a bit of a snapshot analysis post-merger, the emphasis with the new wording of the test is more towards what will change from pre- to post-merger. So efficiencies maybe will find a somewhat more natural place in the new wording of the test.

In addition, we have what we call recitals in our legislation, and those are kind of sentences that precede the operational part of the regulation, and they kind of give the intent of the legislation, and you can find here in the text that we have put, or that the member states have put, I must say.

So, in order to determine the impact of a concentration on competition, it's appropriate to take account of any substantiated and likely efficiencies put forward by the undertakings concerned.

It is possible that the efficiencies brought about by the concentration counteract the effects on competition, and, in particular, the potential harm to consumers that it might otherwise have.

Let me turn to the treatment in the Guidelines. The regulation, of course, is all at a rather general level and so on, but the Guidelines, they kind of provide the analytical approach that the Commission intends to take in the analysis of individual cases.

As I said, the Guidelines were adopted a few weeks ago, 30 January, and, well, if there is any characterization, I guess, of the approach to efficiencies in these Guidelines, I would say it's open but cautious. Open. I think Ilene referred a little bit to that. It's open in the sense that it's, you know, it invites any substantiated efficiency claim. So the Guidelines recognize that in whatever form, efficiencies may make the new entity more competitive. So there is no bias in that sense.

On the other hand, of course, Guidelines must give some guidance, so I will come to that in the next slide. But the opening statement is open, so to speak. At the same time, the approach is cautious. I think that's also kind of natural. It's cautious in the conditions or the circumstances under which the

Commission can take efficiencies into account. I'll come to that on the next slide as well.

But the focus lies on the ability and incentive of the merged entity to act pro-competitively for the benefit of consumers. So while this is a consumer welfare objective, the Guidelines are rather explicit about what is the relevant benchmark in the assessment of efficiencies, and for that matter, in the assessment of possible adverse effects of a merger.

This consumer welfare objective actually doesn't come falling out of the air. It's derived from our Article II that we have which refers to that we should look at technical and economic progress, provided that it is to the consumer's advantage. So it's already in the regulation, and it was in the regulation already 10 years ago.

It's also consistent, by the way, with other articles or sections in our antitrust legislation. For example, Article 81, which also has this consumer objective in the end.

I guess it's more for the discussion afterwards whether the benchmark is the right one, of course, that you can always discuss. But a good thing, I guess, about the Guidelines is that it spells out in a rather visible way and, also, hopefully clear way what are the three

conditions for efficiencies to be taken into account in order to clear a merger for the Commission.

So the first one -- actually, there are like headings, and then the things are further developed. The first heading is Benefits to Consumers, and the relevant benchmark in assessing efficiency claims is that consumers will not be worse off as a result of the merger. This sentence is literally in the Guidelines and it's pretty clear.

In principle, this concerns consumers in the relevant market. You will note that words "in principle" here, and attentive readers can see that the "in principle" was not in let's say in our draft notice, our draft Guidelines. It is in our final Guidelines. So what this means is that the focus is not entirely and completely on consumers in the relevant market, but it's in principle.

I think this is also part of our open approach, given that we have not spent so much emphasis on efficiencies in the past, I think it's better to leave things open while giving clear directions, but leave things open. I think this is more or less the exercise in the Guidelines.

Efficiencies may take various forms. Cost savings leading to lower prices or synergies leading to

new or improved products. We say in terms of guidance, that variable costs are more likely to be relevant than fixed costs, but this does not exclude anything. So in that sense, it's open as well.

Then there are two things which are very familiar to you. There is maybe not much reason to expand a lot on this. Efficiencies must be merger-specific, which means that they are relevant when they are a direct consequence of the notified merger. So it must be a causation there.

And on, you know, the set of alternatives, so to speak, that you look at, you know, are there less restrictive alternatives and so on. On that debate, I think what we did try to do in our Guidelines is to tie very much the relevant comparison with, okay, this is what the merger will produce and how would it likely be in the relevant counter factual, so in the absence of the merger? So that in theory should give two things to -- two situations to compare. It's not -- it's a bit constrained in that respect.

Finally, verifiability. Well, since most of the information is in the hands of the merging parties, when we speak of efficiencies, I mean, it's also incumbent upon them to provide relevant information demonstrating that the efficiencies are merger-specific

and likely to be realized, and it's also upon them to give a first shot or show to what extent consumers will benefit.

I think I will just leave it here for the moment and leave other points or questions to the discussion afterwards.

MR. ABBOTT: Thank you, Vincent, for that very good overview and introduction for all of us to the new European Guidelines.

I'd like to take a brief break to allow -- no longer than 10 minutes. We will be starting up again in 10 minutes time exactly. So if you're late, we'll already be going.

Thank you.

(A brief recess was taken.)

MR. ABBOTT: If people could try and take their seats, please. Let me turn things over for the question and answer session to start out with, Mary Coleman.

MS. COLEMAN: Thank you, Alden. I'll start off asking a question, and I'm going to direct it towards Joe but then more towards the panel generally and in part working a bit off of what Chairman Pitofsky had said in terms of this integrated approach and this sort of formulaic approach.

You had said that, you know, it may be

difficult to have mathematical precision in doing this, but it's sort of an approach that could get people thinking about weighing the different elements of the case. But to try and get to how practical, even in a back-of-the-envelope sense, could the agency do this kind of approach or the parties do this sort of approach? How do you come up with probabilities? How do you come up with reasonable discount rates to actually try and get some numbers?

MR. SIMONS: Well, I think in actual practice, I think companies are doing this already, and the staff is actually doing it already, but it's being done subconsciously. Anytime you evaluate the claims, the efficiency claims of one of the parties, that's what you're doing. You are saying to yourself, okay, what are the chances, how much do I believe this? And sometimes what happens, or I think probably what happens mostly is it's kind of a -- people have in their minds like a binary type of decision or a binary way of thinking. It's either on or off. It's either yes or no, when in reality it's something, you know, largely in-between.

And so, I think, you know, subconsciously, this is being done already and the only thing I'm really suggesting we do is to kind of think about it more consciously, more explicitly. And the place where I say

this coming in is kind of like in a sensitivity analysis. You know, you don't have to know exactly what the chances are that the efficiency is going to be realized or exactly how big it's going to be. But, you know, you can kind of set the parameters. You can do a sensitivity analysis and see how much it makes a difference and in what regard.

And I think people kind of do that subconsciously already. And I think if you just put it down on paper, it just clarifies the thinking.

MR. PITOFSKY: Can I ask?

MS. COLEMAN: Sure.

MR. PITOFSKY: Joe, you're right. I think that your spreadsheet approach and the integration approach is very challenging and it makes a lot of sense. But what's your answer to my question? Would you go to the other side of the equation and say to the plaintiff, even if the anticompetitive effects aren't immediate, if the anticompetitive effects occurred down the road sometime, that's good enough? Or would you stick with British Oxygen which says that's not good enough?

MR. SIMONS: My interpretation of British Oxygen would be that the anticompetitive effect there was speculative. In other words, very, very unlikely and into the future. If what you're talking about is

something that is, you know, is going to occur with some reasonable probability, maybe in two or three years or four years even, then I think, yeah, you should factor that into your analysis. It should go into the whole calculation, and if the efficiencies occur earlier than the anticompetitive effect and there's a price drop, yeah, earlier, then that gets more weight than the anticompetitive effect. But I don't see any reason why you wouldn't consider it.

MR. PITOFSKY: On both sides?

MR. SIMONS: On both sides. I don't see any reason why it shouldn't be done equally.

MR. SCHEFFMAN: Let me say, can you do this? Of course. The FTC, both agencies are incredibly sophisticated and talented in what they do. The problem is the decision making is very ad hoc.

Now, if you take an agency which has much less talent, you know, top to bottom, like the EPA, and you look at the -- and I'm not saying that if you look at their actual decision making there's hot politics and all sorts of complicated things involved -- but they're dealing with weighty tradeoff issues of health versus costs and other sort of things.

They have formal procedures like this to do it. There are well known procedures. Government agencies do it.

Businesses do it in much less complicated and -- much more complicated and contentious situations than we're dealing with in antitrust.

The problem is it's very ad hoc now. There's really no common agreement within the antitrust agencies and within the staff even what the standard is for efficiencies and how they should be weighted.

So it's true that something's going on in different people's heads, but knowing makes them accountable for it. So you can't just -- I don't think Joe is proposing, well, here is the particular analysis. You have to have an agreement. Well, what is the analysis? How are things going to work -- can you come up with programs? Absolutely. You can buy programs, you can buy consultants. We'll tell you how to do that. EPA and other agencies do that all the time.

Is it science? Is it hard science? No. Is it less science than the way we make decisions now? No. It's just making -- it makes a more transparent and rigorous sort of approach.

MR. KOLASKY: If I can just add one comment on this. I think one case that's worth following, because it's directly relevant to this, is the G.E./Honeywell merger case, which is now pending in the Court of First Instance in Europe. Because that, of course, is, in

fact, the central issue in that case where the, you know, Commission's decision found that the merger would make the combined firm more efficient, lead to lower prices, but that would ultimately drive out rivals, after which they would be able to raise prices.

And so it basically is the paradigm example of this issue, and it's going to be very interesting to see how the CFI deals with it.

MR. PITOFSKY: Good point.

MR. KOLASKY: And I'm sure Vincent will probably disagree with my characterization about the reliance on efficiencies, but.

MR. SCHEFFMAN: Let me pick up first, because I don't -- I said something which was -- I didn't mean, and I think was misinterpreted. The agencies take efficiencies very seriously. I don't doubt that. But if you look at process-wise what happens, the only clear guidance staff has is the case law.

The lawyers know they have to be prepared to show your client you can rebut the efficiencies cases that the parties will put forward, particularly in the FTC where you never know whether you have a case for sure until the Commissioners vote. They take it very seriously because they've been very important in Staples and Drug Wholesaling, et cetera. And so there's a lot of

focus on that.

And because of the sliding scale, okay, there's a lot less focus on, well, is the deal really good or not, because in reality, it often doesn't count much. It counts a lot in a gray area. It doesn't count much in a matter in which the legal staff believes they've got a strong case.

Even the economists in that case aren't going to fight much about the efficiencies, because that's not where the game is. The game is whether you can rebut the anticompetitive theory of the lawyers case if you disagree with it. If you win on the efficiencies, you're still not going to win because of the sliding scale.

So that's the problem with the system. That's the process, and if you made the process less ad hoc and provided more guidance to staff -- this is actually how we're going to weigh things. This is how you, you know, we have to think about the fact that none of these things are certain, and don't send up a memo each time where this is absolutely the market definition; that there isn't any doubt about it, and it's just as good as the one last week we sent up, et cetera. If we have more rigor, reasonable rigor in the process, we'd get better decision making.

MS. COLEMAN: Vincent, did you want to?

MR. VEROUDEN: Yes. Just to react on Bill's comment, of course. Well, I'm not here in a position to really say a lot about the GE/Honeywell case. It's also pending in front of the court. But, certainly, the issue was broader than whether, you know, the efficiencies would allow the new entity to lower price and then as a result of the efficiencies, the ultimate result would be a negative one with the other firms exiting.

I think if one could say one thing, the focus of the investigation was whether the new entity would have both the ability and the incentive to kind of embark upon the strategy to marginalize in some way or the other the rivals in the markets concerned. So it's a bit broader than just giving it the label “efficiency offense.” That's the only thing I want to say at this stage. And let's just leave the debate for what the CFI is going to tell. Thank you.

MS. COLEMAN: Another question that was brought up by some of what Chairman Pitofsky said and by Joe's analysis, is the time horizon over which we are looking at, both effects and efficiencies and the net effect of the merger and what the panel thinks about what type of time horizon should we be looking for. You know, is it two years, which some parts of the Guidelines sort of suggest? Should it be longer? Should it be different

for the effects versus efficiencies? And I'd open that to the panel for people to comment on.

MR. GIDLEY: Well, let me field that first. I think, first of all, there is a certain amount of inherent factual difference between industries and between deals.

So some deals and some mergers, I think, truly are permanent in the sense that, you know, you do -- Boeing/McDonnell Douglas, the chance of somebody else getting into commercial aircraft manufacturing on large-scale jets is very small. On the other hand, McDonnell Douglas maybe was already out by the time of the deal.

So I think it depends a little bit on the industry. I think in some service and retailing industries, I think there's a more dynamic process where, you know, mail order and internet compete more and more for dollars. So I think the first observation about time frame is, it depends, meaning it depends on the industry, it depends on the product, it depends on the firms and what's likely down the road.

I think the second thing, and frankly, I hadn't focused on it as a practitioner, is, from the standpoint of time frame on efficiencies, that footnote 35 explicitly says that timing matters, I think, is under-emphasized by the merging parties in their defenses. And

so that's an example of good text that's in the 1997 Guidelines, and that again, Chairman Pitofsky, is something where I credit the Clinton Administration for improving on the '92 Guidelines.

There is some explicit recognition that timing should matter. I think those of us who counsel Boards and CEOs and management see spreadsheets that go out five to 7 years as just being the normal horizon for evaluating a merger, and I think that's a data point that we shouldn't explicitly just ignore in the analysis.

MR. SIMONS: I was just going to say, it really does depend, and there are some firms that do -- are very acquisitive, and, you know, they have histories of having achieved cost savings. And for those, you know, it's basically whatever you can prove. And if you can't prove it, you can't prove it. The fact that you think it's going to occur, you know, six years out is kind of irrelevant if you can't prove it. You have to have some -- you have to have good evidence. You have to have evidence.

MS. GOTTS: But your model, Joe, actually takes into account the idea that it's a longer term and appropriately discounts it, and that's the way it should be done. They shouldn't be thrown out because it could take a while to be able to integrate the two companies

and really realize those, and those are benefits to society.

MR. SIMONS: Right. And the timing, the risk adjustment should also take into account not only the chances that -- well, I guess what's going to happen is the longer out in time, just as a general rule, the chances that the efficiency is going to be realized are probably lesser. But, you know, you can just figure that into the calculus.

MR. ABBOTT: Bill, you raised the issue as to the tradeoff between producers and consumers' surplus. Do we have a true pure consumers' surplus standard? Or are there situations in which, say, a diminution of consumers' surplus in one market can be traded off against a countervailing gain in producers' surplus that's so large, that swamps the loss in consumers' surplus, and you would allow the merger to go ahead? How -- what standard would you apply, or is that consistent with the case law? Can you apply such a standard?

MR. KOLASKY: I think I'd give both a lawyer's answer and maybe a prosecutor's or economist's answer. Certainly, under the statute, as Bob correctly points out, the standard is whether the merger is likely to substantially lessen competition in any line of commerce in any section of the country.

And so what you are looking at is what is the impact going to be on consumer welfare? Is this merger going to lead to higher prices and lower output, and if it is, then it should be found anticompetitive. I think in making that determination, obviously you have to take into account efficiencies, including those, as we've been saying that will kick in over the long term and outweigh any immediate impact on short-term prices.

The harder question is, and I think producer surplus is relevant there because, to the extent the merger increases producer surplus, that is likely to make this market one which, you know, may be more attractive to entry from others because it's now suddenly a more profitable market. And so this may actually over the long term stimulate competition and stimulate entry. And therefore, you know, I think that's the point that was being made by footnote 37.

I think it's also very important as we think about this to have a very clear understanding of what we mean by "competition." And this goes to Bob's point. Many mergers that we might characterize as a merger-to-monopoly because it's a two to one merger or near monopoly because it's three to two, do not in fact lessen competition in an economic sense.

They may reduce the number of rivals. But as

Baumol makes very clear, you can have a very competitive market with two rivals, or actually in some cases even with one rival, where that rival has to constantly improve its product and innovate in order to get people to abandon the product they bought in the past and buy their new product. Your revenues are going to go away if you've got software that lasts forever and you don't improve it so that you give people an incentive to buy the latest version of it. And we have to take into account that kind of competition with the installed base.

The other point, though, is even if you have pure producer surplus that is not going to inure to the benefit of consumers, why wouldn't you take that into account in exercising your prosecutorial discretion as to whether or not you're going to bring a close case? If the potential anticompetitive effect seems to be quite minor, if the probabilities are in doubt, as Joe was pointing out, but you know there are going to be very substantial producer's surplus created by the merger, maybe that's one that you ought to just take a pass on as a matter of prosecutorial discretion.

MR. PITOFSKY: Yes. A couple of reactions. On the last point, absolutely right. If there are no or little barriers to entry, there's no market power, and therefore you don't have to worry about anticompetitive

effects. It's not common, but when it's there, when that's the case, absolutely right.

On out-of-cross-market efficiencies, let me tell you, with the privilege of someone who was there at the drafting. You couldn't say, look, if you let us merge, prices will go up here but we'll be better competitors in Europe or better in Florida, or better in California. The statue doesn't allow that, and the cases interpreting the statute don't allow that.

On the other hand, as a matter of prosecutorial discretion, we kept thinking to ourselves, suppose the advantage of one market is enormous and the disadvantage in the other market is slight. So we stuck in a line with a very felicitous phrase, something about inextricably interwoven, which nobody has a clue what we meant there.

(Laughter.)

We said rarely -- I think we used the word "rarely" twice. It's just a question of leaving some discretion to the Commission in the most extreme of cases.

Now, one might say, well, if you're going to trade off anticompetitive effects in New York for pro-competitive effects in Florida, why won't you trade off anticompetitive effects now for pro-competitive effects

four years from now? It's a close call, and it's a good question.

But I think when we're doing New York versus Florida, it's right in front of us. This is all predictions, by the way. Everything about merger analysis is prediction. But I think you can make a more confident production, New York/California, as of the time of filing the suit or letting the deal go, than you can higher prices now, but, oh, four or five years from now, prices will be lower.

That's my definition of speculative, uncertain, clearly not allowed by the statute, not by the Guidelines. The Guidelines never thought of that being an elaboration of an efficiencies defense, and I'm still there. It's true, it's close to cross-market, but it's enough different that I think it throws you into a kind of a never neverland of speculation.

MR. SIMONS: Let me just respond for a second. I could make the argument that the cross-market thing, as you've said basically, does not -- is not permitted by the statute. But that the temporal tradeoff is, because the statute says substantial lessening of competition in any market in any part of the country. It says nothing about time frame.

So, I don't know, I could come out the other

way.

MR. ABBOTT: One issue that underlies some of the discussion is burden. What burden should the merging parties have to meet to prove up their efficiencies? I mean, we know they must be merger-specific, cognizable, the buzz words, but as we've heard some critics have talked about a chicken-and-egg problem; the fact that poor efficiency arguments are made or developed because parties don't think staff will treat them seriously, or alternatively, staff doesn't spend as much time on them because they're not well made and documented.

What is it? And as practitioners, what standard do you think should apply? Should better guidance be given by the agencies as to what degree of specificity needs to be met or proven by the parties?

MS. GOTTS: Actually, during the break, Marius and I were talking a little bit about not only that, but one other aspect of it, which Dave Scheffman in an article touched upon.

Unfortunately, when we do deals, when you start out a lot of times the group that is able to be in the know about the possibility of the deal is very limited, to a CEO, maybe a chairman of the board. And so that might be why, before the deal is announced, you get two X in efficiencies that are alleged.

After the deal is published -- out there in the public domain -- you can do a little bit more work, but there are still limitations which we impose as antitrust lawyers in how much the companies can get together and really drill down in understanding how much the efficiencies will be from a deal.

And as you get closer and closer to the deal, maybe we loosen up a little bit, but we still are concerned, especially in deals where they're among competitors.

And so this really adds to the difficulty in saying the parties should have some real strong burden of proof and that somehow it should be that you give less credibility to the efficiencies that are discovered by the parties after the deal is announced than what the board considered as you went forward in doing it.

So this makes it more complex than even just who has the burden of proof in front of the agencies. It's also a timing issue and a difficulty issue.

One other thing. Both the Guidelines, and the agencies are always saying, well, the parties are in better control of the documents and the evidence to support it. That's not always the case. Sometimes -- you have subpoena power. You can find out what other deals in the industry, what other third parties have achieved in the way of efficiencies that we don't have

access to.

So it really has to be not so much the burdens of proof, but we're all trying to get to an answer here, a sense of whether or not this deal is going to be good or bad to consumers, and you as the agency should be using whatever power you can, the parties should, as much as they can within the confines of antitrust restrictions, be trying to get you the information you need.

MR. KOLASKY: If I can add just one thought to that, and this comes back to the title of this panel, and again, this is based both in my private practice experience and my time at the agency, and that is that I think the private bar needs to understand better that efficiencies really have now been integrated into the merger analysis that they are not just a quote/unquote "defense." In fact, they're not a defense at all. They may be used to rebut inferences of anticompetitive effect arising from other factors.

But my experience now is that, as the agencies have focused more attention on efficiencies, if you don't have any efficiencies but you've got a horizontal merger between major competitors, that is actually a major negative now. And in fact, in G.E./Honeywell, coming back to that, one of the arguments that Gerte Strauss and

others have made is that in that case, the parties didn't argue any efficiencies, and that was held against them.

I think that the message that the agencies should be sending through speeches and otherwise is, if you have a horizontal merger between two major competitors, you'd better have some efficiencies to talk about. Because if you don't, we're going to be very skeptical as to whether or not your real motive is to gain market power and increase price.

MR. SIMONS: Can I say something on the burden?

MR. ABBOTT: Sure.

MR. SIMONS: When you raised the question about the burden, who should have the burden of doing what, the following example occurs to me. Greg Werden actually has a really nifty article. It's like seven or eight years old now, in which he shows, he says, okay, if you think what's going on here is unilateral behavior a la Bertrand, here's the cost savings, the marginal cost savings that have to be realized in order to offset the price effect. And he does it by -- you've got a table. It's by margin, and it varies by diversion ratio.

And suppose you had a situation in which, okay, the staff thought that was the type of model that was applicable, and the parties came in and showed, yes, here's the marginal cost reduction that's going to take

place, and there's no effect, all right? And you presented that to a court. And that's all that was there. What would the court do? Well, it would seem to me the court would have to conclude there was no effect.

And so the burden would seem to be on the government to come back and say, yes, but this effect could be achieved a different way, and here's the way in which it would be achieved and here's the time period over which it would be achieved.

So in terms of what would happen in court, I'm just visualizing that kind of circumstance, it seems the burden really has to be on the government.

MR. SCHEFFMAN: Let me mention the burden, and I've written on this. People in business don't write 100-page single-spaced memoranda analyzing things. Now, that's not to say the government should take things, you know, whatever is proffered. But there has to be, and I think there is, some amount of sophistication, particularly by the financial analysts, about what you should expect to see in a deal.

We tend to think that there's things there and you push buttons and things happen, and that's the way business works. That's not true. So you might in a consolidation merger say we're going to get $50 million in cost savings. Where does that come from? Okay. Well

it comes from some sort of analysis or explanation, but what it is, is a goal that some manager has to meet. At least that's what it better be, or we shouldn't pay attention to it.

And as Ilene said from Sarbanes-Oxley, if you say it to the Street, you are going to be accountable. So one of the management tools is saying we understand this much about the other company. This is your target. Go achieve it. They're not going to get down into micromanagement of how you do it. So whether cost consolidations are a savings or not, you shouldn't expect to see a lot of detailed analysis of them. Now, when you get to the more sophisticated stuff, which I agree might be much more important, I think you have to be able -- you know, it's reasonable for the agencies to require more. And that may be difficult to prove.

But I do think that a very important source of evidence is to ask, you know, show me where you've done this before. Have you done something like this before? Have you done some other deal before? Or show me what you did in a similar circumstance. I think that's very important evidence. I think it's credible to anyone including most decision makers. It hopefully the situation should be analogous. And if we did more of that, we had some of that at the FTC, if we did more of

that, I think the agencies would understand the way businesspeople make decisions and how they make things happen and why they may work and why they don't.

MR. ABBOTT: Well, thank you, Dave. Anyone have any additional insights to add on that topic?

(No response.)

Well, if not, we're close on the noon hour, and believe it or not -- yes?

MR. KOLASKY: Just one quick thing. I want to come back to the title of this panel and really emphasize this point about integrating efficiencies into the analysis. And this goes back to one of Bob's comments in response to some of the criticism of Heinz/Beech-Nut, and it's a very important point.

And that is, you know, Bob said that Beech-Nut and Heinz were competing like crazy. And that's true. They were competing like crazy in order to get on the shelves of supermarkets. And as a result of that, what they were doing is bidding up their distribution cost. So actually, that competition wasn't benefitting consumers. That was competition that was raising their costs relative to the incumbent dominant firm, Gerber.

And what that points up is the importance that as you think about these issues, you think about efficiencies, you also think very clearly about what you

mean by competition.

MR. SCHEFFMAN: Let me just say, I have to attack Bob.

(Laughter.)

He said something that just drives businesspeople and a management professor crazy. If there's one thing that's clear about the evidence and research, it is by far the most important reason for a company's success is organizational excellence, not leadership, not CEO, which can be pretty important. If you got Jack Welch as the head of K-Mart seven years ago, it would be better off. It might still be out of business. I guarantee you, if Wal-Mart would have bought it, it would be very different.

It's not just about changing the leader. It's about changing the culture and the middle management, the whole system. You can't take that on spec. But if you can show they did it before in similar circumstances and it worked, that should be very compelling evidence. And it's quite undeniable as a matter of research in management that that's probably the realest sort of efficiency and the realest basis for competitive excellence is organizational excellence, and the hardest thing by far to create.

MR. PITOFSKY: I respectfully dissent.

(Laughter.)

MR. ABBOTT: On that happy note, we've got alternative views of efficiency, competition, and enough to keep us here for an additional week. But we have to close down. I want to thank all of our panelists for our a great discussion and provocative and excellent papers, which will be posted on the FTC's web site very shortly. Yes, shortly. Time horizon is important. We must keep -- we're not predicting the exact date.

And this afternoon, of course, we have a great treat. We have Assistant Attorney General Hew Pate will be moderating a final roundtable.

So thank you again for attending, and have a good day.

(Applause.)

(Whereupon, at 12:02 p.m., a luncheon recess was taken.)

AFTERNOON SESSION

MR. PATE: Good afternoon. I'd like to welcome everyone to the Attorney and Economists Roundtable session of the Joint FTC/DOJ Merger Workshop that's been occurring over the last three days.

Tim Muris and I, in talking about the arrangements for this panel, thought that it might be a good idea for he and I jointly to moderate this last session, and we were set to do that until his travel schedule took him out of Washington, so you've been pretty bitterly shortchanged on the moderator, but you've been left with an excellent panel.

I'm going to introduce them briefly and then we'll move into questions and discussions -- what I hope will be a very lively exchange on the topic of merger enforcement. I expect that we'll go until right about three o'clock and then maybe take a brief break and resume say around 3:15.

I want to welcome and thank all the people here, both people from the agencies and outside parties who are interested in this topic and also welcome our FTC colleagues who are listening on the web, and those who joined us on the dial-in number for today's session.

I think for anyone who cares enough about any of this to turn up on as beautiful an afternoon as this

knows who all the people are on the panel. Nonetheless, I'll go through and give a brief introduction in alphabetical order. I'll also disclaim any responsibility for the seating order. On a panel with this much expertise and ego, it would be very dangerous to take credit for doing that.

(Laughter.)

And so I have no idea how it's been done, but I'm sure it was after extensive and thoughtful study. Alphabetically, Bill Baer is the head of the antitrust practice in Arnold & Porter and served as director of the FTC Bureau of Competition from 1995 to 2000 and held other positions prior to that at the Trade Commission.

He is a frequent advocate before the agencies and in court. He has been rated by one publication at least as quote/unquote "the best" antitrust lawyer in the United States and has appeared on two American Lawyer covers.

Going next alphabetically, Jonathan Baker is a professor of law at American University. He was director of the FTC Bureau of Economics from 1995 to '98, was a senior economist at the President's Council of Economic Advisers from 1993 to '95. He's the author of numerous articles on topics pertinent to today's program, particularly entry and empirical analysis in the

evaluation of mergers.

Dennis Carlton is also with us, who is a professor at the University of Chicago, professor of economics, previously taught at MIT and is well known to many of us through his work at Lexicon in analyzing a number of very significant transactions that have appeared before the enforcement agencies.

He is the author of numerous academic papers, two books, and has won a lengthy list of academic prizes, and we're very fortunate to have him here today.

Dale Collins is an antitrust partner at Sherman & Sterling. He's also someone to whom I am indebted for having sent two of the best young lawyers I've had the opportunity to work for to the antitrust division as counsel, Dave Wales and Jim O'Connell. Most people try to send you the folks who are really not quite the best ones in their practice, and Dale actually had the goodness of heart to send us some terrific people, and I'm going to be grateful for that for a long time.

He was a White House Fellow, was a Deputy in the Division under Bill Baxter, has taught at Yale and has appeared in a very large number of major transactions at the agencies as well.

Next to dale is Jim Loftis, of Gibson, Dunn & Crutcher. His 25-year career has included a stint as

head of the ABA Antitrust Section. He has truly been involved in all aspects of antitrust litigation and counseling from mergers to criminal antitrust enforcement. He's a frequent lecturer, a contributor to over 20 publications, and is also a professional race car driver, which is certainly the most interesting thing I can say about anybody on the panel.

(Laughter.)

Jim Rill, of course, is a predecessor of mine. He served as Assistant Attorney General of the Antitrust Division and also has previously served as chair of the ABA Antitrust Section. He now is co-chair of Howrey & Simon's leading antitrust practice. He has served on numerous committees dedicated to advancing the thoughtful enforcement of antitrust, including serving as co-chair of the so-called ICPAC Commission, which has had great effect in terms of the international spread of antitrust enforcement and increasing the rigor and the soundness hopefully of that enterprise. He has appeared in numerous cases both here and abroad before antitrust enforcement agencies.

Dan Rubinfeld is a Robert L. Bridges professor of law and economics at Balt Hall, where he's been since 1983. He taught at Michigan prior to that. He likewise has served as a Deputy Assistant Attorney General at the

Antitrust Division in charge of our EAG shop.

He has served in numerous capacities as well, including with the Council of Economic Advisers, the National Academy of Sciences, the National Bureau of Economic Research, is the author of a number of books and numerous articles on a wide range, not just of antitrust, subjects, but also other public policy issues.

And last but certainly not least for today's topic, Bobby Willig is a professor of economics and public affairs at the Woodrow Wilson School at Princeton. He is the former supervisor of economic research at Bell Laboratories, has authored a number of significant works, including welfare analysis of policies affecting prices and products, contestable markets and the theory of industrial structure, and he is the co-editor of the Handbook of Industrial Organization.

Bobby likewise served as the economics Deputy at the Division from 1989 to '91, and he too is the author of numerous articles and has been a participant on numerous policy task forces.

So suffice it to say, you've got a terrifically qualified panel. The format that I think we'll follow is for me to pose a number of questions and try to excite some comment from the panelists and maybe even provoke some exchange among the panelists.

And what I want to do first is throw out a very general question which I would put this way. I'm interested in knowing what single change the panelists would most like to see in terms of merger enforcement in the next decade, and that could include either suggesting that the agencies should do something differently than we're doing now, that we could be more transparent about the fact that we're doing something that we're already doing, or literally anything that you think would be responsive to that question.

And with that, I hope maybe I could get a brief reaction to that question from each of the panelists, and then we'll move on to some other questions after that. Does anyone want to take a first stab at it, or should we go back to the alphabet?

VOICE: Reverse order.

MR. PATE: Reverse order.

(Laughter.)

MR. PATE: Bobby, do you want the first word?

MR. WILLIG: Absolutely. I thank you for that. Because I can't tell you how often it is that chairpeople of important panels cite alphabetical order as the natural way to order participants without underscoring the assumption that alphabetical order starts at the beginning of the alphabet. That is completely arbitrary

and unfair. But never mind.

(Laughter.)

I think the biggest change, and this is a setup for the question about the next set of changes over the next decade, but the biggest change in the analytic framework used for merger enforcement has been the advent of simulation analysis.

And as you all know, that's the systematic use of analytic methods to actually try to quantify the impact of a proposed merger where the simulation machine is based on economic logic and also on some calibration of the parameters either derived econometrically or through other sources of information.

That's been the biggest change, and the change that I'd like to see most going forward is first a continuation of that trend, but more major progress on our capabilities of using those tools well and reliably for public policy purposes.

An important part of that for the agency is to try to be within the bounds of confidentiality, try to be more interactive with the parties in terms of sharing the analytics, because they are in such an evolutionary phase of their development. They're so uncertain.

There is so much analytic R&D that it's of exceptionally great importance that the parties share

their work with the staff and the agency and vice versa, that the agency share with outsiders exactly what their own work is producing, how it's evolving, so that there can be a meeting of the minds in terms of the most reliable set of methods to use.

The other thing I want to throw out, and I won't say much about it to take the time now, but I would love to see in the coming years more organized capability in the community for handling R&D or innovation issues and some appendage to the Guidelines that I think I hear you're going to show us about 3:30 today, you promised.

(Laughter.)

The new R&D innovation markets Guidelines. How should we really handle those concerns? How should we also blend in the possibility of efficiencies in innovation markets, more efficient R&D perhaps as a result of the deal, and how can that all be blended together in the sense of Guidelines for handling those issues?

MR. PATE: Okay. Thanks. Dan?

MR. RUBINFELD: I agree with most of what Bobby said, so I can't start a fight just yet, so I'd like to start on a different subject.

One of the things I know the agencies debate a lot internally in merger cases is whether they should use

a consumer interest standard or a broader social welfare standard. And while there's a lot of debate, it strikes me that most of the time ultimately, partly because of the law and partly because of internal policy decisions, the consumer standard wins out.

And I would like to see more thinking about taking a broader social welfare perspective in looking at mergers. The easiest case to make for that, but it's only the easiest case, would be in cases that involve possible increases in monopsony power, where arguably the effect of the merger could be to lead to lower prices or inputs to production. And it seems to me in that particular case it's easy to argue that we ought to balance the benefits of those lower costs to producers with possible higher costs down the road. And more work in thinking through how to do that tradeoff and make it practical I think would be a nice change.

MR. PATE: Okay. Thanks. Jim Rill?

MR. RILL: Thank you. I think perhaps the most significant evolutionary change since the '92 Guidelines, one that was well underway since the 1968 Guidelines, and punctuated dramatically in the 1982 Guidelines, is the trend away from reliance on structural formulations for merger decisions.

And I think that with the '92 Guidelines and

the developments since the '92 Guidelines and the increasing willingness of the courts to go beyond structural analysis, we're getting into a full blown and healthy analysis -- quasi rule of reason analysis -- of horizontal merger decision making.

Having said that, I don't think it's time to change the Guidelines' numbers, because I don't think the numbers mean a hell of a lot anyway, other than perhaps a trigger towards further analysis. But I do think perhaps it's time to consider whether or not the presumption itself is a realistic presumption and whether structural analysis should only be a gateway to further analysis without the incubus of a presumption it still has an opportunity to cause mischief in some cases, not so much looking at the outcome, for example, but the rationale of cases such as Swedish Match, in which I hasten to add I wasn't involved.

I do want to address for a second Bobby's comment on the trend toward simulation analysis, which is certainly there and a recognizable trend. I'm concerned that an early and overly romantic grasp through simulation analysis in the absence of strong empirical evidence that supports the analysis, or which in fact I would prefer to see the analysis support, could lead to false conclusions based on a false recognition of

quantitative accuracy, which I don't think necessarily would be borne out if we have the full, rich empirical basis that would support that kind of an analysis.

Finally, just a quick pitch for the ICPAC. It seems to me that one of the salutary developments that's taking place as a result, I think, of the U.S. Guidelines and outreach effort has been greater convergence of antitrust merger analysis recently, for example, evidenced by the EC's merger regulation and guideline revisions, which I won't say it is attributable in measure to the U.S. effort, but certainly reflects a convergence of the analysis between the jurisdictions.

MR. PATE: Okay. Well, there's a lot in there, and it's all very polite, but maybe the makings of at least some pointed discussion later. Let's see. Why don't we move to Jim Loftis.

MR. LOFTIS: Well, let me touch on what others have identified as subjects of interest. On simulations, I think that to the legal community, simulations are not well understood and tend to be viewed as unreliable. So I would very much agree with Bobby's observation that that is an area that needs additional work, additional exploration, and considerably more than just refinement before it's going to be well accepted, at least in the legal community.

I would very much agree with the observation that R&D markets are not well understood. They're not well handled under the existing Guidelines in times where there's not a plethora of transactions going on. We are seeing transactions in high tech markets and we're seeing lots of transactions in the defense industry where concentration is high and R&D on new products is critical.

So there's a lot of action in that area, and the guidance that's being given is largely transaction specific and therefore invisible to the community.

Monopsony is an intriguing problem that doesn't get much attention because there aren't many cases. People just don't have the occasion to give it very much thought. And so I'm not sure that I would devote a lot of resources to worrying about it, but I certainly would agree that it is an area that's poorly understood.

And on Jim's comment about the trend away from structural analysis, I would certainly agree that that is a trend, but I would question whether it has had as widespread an impact as I think we all would hope. And I certainly would identify as one of the, at least my top 10 favorite faux pas, the agency, which will go unnamed, briefed to the court that an HHI of 510 should presumptively entitle it to relief.

And with that, I'll pass.

MR. PATE: Okay. Dale?

MR. COLLINS: Well, I think as far as the biggest change is concerned, and you have to recall or remember, I'm from the outside sort of looking in. I haven't been on the inside in a long time. But I think if we go back to around 1992, the years before that, and you look what's happened since then, I think around 1992, the Guidelines actually did provide a fairly accurate description of the analytical paradigm that the agencies went through when they were analyzing cases.

I think today it provides no description of what the agencies actually do in coming to the prosecutorial decision. It does provide a vehicle for them to explain what they've done. But if you're on the outside and you're looking in, one of the things you'd like to have is you'd like to have a good predictor, okay, to be able to test whether or not a particular deal that you're thinking about, that your clients are thinking about doing, how it's going to be analyzed at the agencies. And I'm happy to discuss this at length if anybody wants to.

I don't think that the Guidelines are a good predictor at all, and I don't think descriptively they actually convey what is going on in the agency. So

that's what I think the biggest change has been.

Now as far as what I would like to see, first of all, I'm not going to say what I'd like to see is a rewrite of Guidelines. I still have an open, quite an open mind on that, because as I say, I think the Guidelines provide a very good analytical tool for explaining decisions that have already been made. And it does force some discipline into the explanations.

So the question of whether or not you have to have Guidelines that both describe the decision making process as well as, if you will, the rationalization of the decision, I'm not sure the two have to be the same.

The thing I would love to see, which I beat up on Joel Klein to do, Joel, you'll remember, when he first came in said there's this big divergence between what the courts have to say about merger law, about antitrust law generally, but about merger law in particular, and what the agencies are actually doing. And he says what I'd like to do is bring more cases in mergers so we could get more convergence. I said I've got the tool for you. Do contingent consent degrees. That's what I'd like to see.

A contingent consent decree is a consent decree where the parties agree on relief but the relief is entered only on the condition that the court finds there's liability. And I can tell you from some personal

experience that if the agencies were willing to do contingent consent decrees, they would find themselves in court more often than they do today.

(Laughter.)

MR. PATE: Dennis?

MR. CARLTON: Well, I agree with a lot of what's been said, but I also disagree a bit with some of it. So let me just briefly summarize. I think I agree with Dan that there should be more thinking about what the goal is, whether it's a total efficiency standard or a consumer welfare standard.

In the United States, I don't know if it would make that big a difference, but certainly in other countries it will. And the United States is being used as a prototype for antitrust laws around the world. And it's a big question, especially in small countries that rely on international trade.

And it goes even beyond antitrust. The question is whether an antitrust authority should be the protector of property rights for consumers. Do consumers have a property right in competition? I think that's a good question. It goes to the efficiency of government and perhaps corruption. And thinking on that question would be helpful.

More specifically related to the United States,

there has been a body of work that I really think needs more attention in the application of antitrust, and it's work by -- and the reason I know is I just revised my textbook again, and when you revise your textbook, you always try and put in what you think are the most important developments. And I think the work of John Sutton is very important. And let me just illustrate two points that I think are related to some previous comments.

Sutton shows that there are some industries in which competition is naturally vigorous, all else equal. They're just naturally more competitive for whatever reason. In game theory terms, they're playing a more competitive game.

In those industries, there is an inverse relationship between, or can be, between concentration and price. It completely reverses our usual notions of price and concentration. The more concentrated the industry, the lower the price.

Second, he emphasizes that in some industries there is another dimension to the product -- R&D, advertising, quality -- and you get exactly the wrong intuition if you ignore that other dimension. And that is related to the earlier comments about better understanding dynamic efficiency, better understanding

the incentives for technological change.

It's a hard question. Economists don't know as much as we should about that question, but I'm always worried when you're analyzing a dynamically changing industry with static tools that you're going to get the wrong answer. And indeed, one of the interesting findings in Sutton's research is that as markets get bigger, you don't see more firms. You may see just the same number of firms, but they invest more and more, so they get higher quality products.

That's something I've not seen really absorbed yet by the agencies. I think that innovation markets are a very bad way to go in terms of analyzing mergers. I was involved in one of the early cases with innovation markets, and it's easy to show that they're unpredictable. If you ever do a retrospective asking five years ago, who did I think would make major innovations, you're invariably wrong when you ever test your intuition, or how well you were doing.

As far as merger simulation, this has been an innovation in practical enforcement. I think we have to be very careful here. I like it. On the other hand, there are big red flags. Let me explain why. When you do a merger simulation, there are two things that are done that are dangerous. You start out with an

econometric estimation. There are possible problems with that.

If you get the form right and work hard enough, that's very informative. And then what you do is, you estimate costs. How do you estimate costs? You kind of invert the equilibrium condition based on some assumption of how competitive the industry is. Where does that assumption come from? Usually out of thin air. So you're estimating cost from demand information and a guess about competition. That could lead to great errors.

But then the next thing you do is you simulate. You simulate what happens when two firms merge. What's going to happen? You must make an assumption about competition that's current and that will occur after the merger. But competition that will occur after the merger is exactly what we mean by coordinated effects. And these merger simulations always take that as constant, okay.

So I think it's very dangerous. I think it's a helpful way of interpreting demand econometric estimation. It can be a dangerous way of predicting what's going to happen. And I don't mean to state by that that it's not useful. But there is a trend in academia for the use of what's called structural -- and

it's not the same way Jim has used the term -- estimation, in which you estimate demand parameters and supply parameters in great detail and then simulate.

I want to point out, the question an antitrust authority wants to ask is, what happens to price if two firms merge? That is what economists call a reduced-form question. You can indirectly answer that by a merger simulation. But if you ever have an experiment where you see price in one area with fewer firms versus price in another area with more firms, as long as you can control for the reasons why you have more firms in one area than another, that is the direct question an antitrust authority wants to answer. And I have been worried that there's a trend away from such analysis.

MR. PATE: Okay. Jonathan?

MR. BAKER: Well, there's been so much going on here in this conversation that I don't know where to start, and I certainly am not going to try and comment on every little piece that we've talked about.

So I'll start out by observing that I think the most interesting change, or greatest change in merger enforcement since '92 Guidelines has been the revival of coordinated effects analysis, which was very healthy, but that the problem with it is that some people seem to take the view this is an excuse for not paying attention to

unilateral effects.

And my concern for the future is to revive unilateral effects, particularly the loss of localized competition analysis among sellers of differentiated products. Every serious antitrust enforcer, as far as I know, accepts that the theory makes sense and that it was an appropriate addition to the merger Guidelines in 1992, and a host of legitimate technical issues have been raised about the application of some of the tools, particularly during the current administration, including discussions of simulation models which I'll get to in a moment.

But Greg Werden and Luke Froeb and others have responded appropriately by working to improve the tools and develop ways of testing their robustness to potential problems. And a healthy debate about methods of analysis is not a reason for skepticism about the theory.

So if you ask where in the Guidelines would I want to tinker, perhaps it's that 35 percent market share safe harbor for unilateral effects when it applies -- to the extent it applies -- to the loss of localized competition.

There's a dispute as to whether the words actually do apply there, although it certainly was the intention of Jim Rill, as I understand it, to do so. But

the problem is that unilateral effects having nothing to do really with market share. So when you have this 35 percent safe harbor, you risk failing to challenge potentially anticompetitive mergers, but you also put pressure on the agencies to be defining narrow markets in unilateral cases because of how they have to prove the case with the 35 percent safe harbor, which could be troublesome as quantitative effects becomes revitalized, and you're looking at how the agencies define markets for unilateral effects purposes.

But I agree with those on the panel who have said that simulation models are a good avenue to pursue in trying to do better at understanding mergers. Particularly, I think they've been useful in unilateral effects areas. That's really where they've been applied most successfully to date.

Because at a minimum, and I'm just saying something a different way than Dennis said -- simulation models can provide a useful metric for understanding what the demand elasticities mean.

Now if you want to go farther and start thinking about how seriously do we take the predicted prices, some of the cautions that Dennis and Bobby raised I think are appropriate. To be convincing, we need to recognize that most simulation results depend on a host

of assumptions, and we have to defend the assumptions with evidentiary support. It doesn't have to be -- it could be econometric, but it could also be documents and testimony.

And we also have to employ robustness tests and understand which of these assumptions really matter to the outcome, to which is it sensitive to and which are the results not, and then work harder when we find that there's some assumption that's really important to make sure we really believe it.

But with those kinds of caveats, this is a potentially very useful tool and has been so so far and is worth pursuing going forward.

MR. PATE: Okay. Back to the end of the alphabet. Bill Baer.

MR. BAER: I should say as a preliminary matter that as a product of the Catholic elementary education system where the nuns sat us and called upon us alphabetically, I used to go to bed at night praying my name started with a W.

(Laughter.)

It's nice to be able to go last for a change.

VOICE: Was your prayer rewarded?

(Laughter.)

MR. BAER: No. Just today. A couple of points

I'd make is -- we're going to talk more about modeling merger simulations, and in terms of looking forward as to whether we should be changing our approach to analysis, this is obviously going to be an incremental, gradual process as the lawyers become more familiar with the concepts, as the enforcers test out their systems or not.

It is not something that I think anybody on this panel is suggesting is a breakthrough that ought to radically alter the way enforcement ought to be taken going forward.

I'll leave that and go to a couple of process things that I think actually the agencies ought to be focusing on in the next couple of years. One is the chronic problem of the burdensomeness of second requests. I would love to see some of the wonderful energy that's been put into developing the joint concentration studies that were released in December in terms of merger challenges and the FTC data put out two weeks ago on what seemed to influence decision to take a enforcement action or not, into looking at what value comes from the volume of production that is associated with the typical large second request.

I'd like to know the percentage of boxes that are never opened, much less read. And I say this as one who failed to get control of the process when I was in an

enforcement role at the FTC. But it is costly. It is burdensome. I don't think this process actually in terms of the volume of materials coming in is in any way materially improving the quality of merger analysis.

I had a little study done shortly before I left the FTC of the 10 most recent big deals and where the good documents came from, the important documents that were cited in the memo that made an impact, and they come from the same files. They come from the strategic plans. They don't come from the e-mails. They don't come from the seller invoices. Obviously, if we're going to do quantitative work, we need to find a way to get our hands on data, but that's a separate point.

So that's one process issue that I think is really important. It does tax mergers -- slow things down that otherwise ought to be speeded up.

The whole problem with clearance remains an issue. Hew and Charles and Tim did a great job in terms of trying to come up with a system. It fell apart because of some concerns, arguably legitimate, about whether the allocation was right, but finding a way to make more productive use of that first 30-day period continues to be a challenge for the agencies. And if they could come up with a system two years ago that got the average clearance time down to a day and a half, they

ought to be able to come up with something that reduces it from its currently 10, 12, 13 business days.

And then a final point that I'd just throw out is, if you look at divergence between the agencies in terms of enforcement, probably the most significant one is with respect to approach to merger remedies and the FTC's insistence, in which I was a major part in terms of advocating, on finding buyers up front before the deal closes, and the Antitrust Division's significant reluctance to pursuing that approach.

You have right now as big a divergence in terms of approach to merger remedies as I've ever seen. And it would be, I think, helpful and productive for the agencies to focus on that going forward and see if they couldn't come up with a more consistent, coherent approach. You should not be as affected as you potentially are today as merging parties by that kind of divergence in approach.

MR. PATE: Okay. Good. A lot of themes. I'd like to follow up. It seemed that simulation analysis maybe was the most frequently mentioned topic, so why don't we stick with that for a while and let me invite anyone who has a follow-up, having heard the other comments. Bobby?

MR. WILLIG: Thank you. Two kinds of reactions

to what's been said. It is true that to do a simulation analysis requires an enormously long list of assumptions, and it's true that for an economist seeking to be true colleagues with our lawyerly counterparts and teammates, it takes a really long time to explain all this.

It also takes a long time to explain it to each other, but we've got the benefit of some common textbooks like Dennis's to fall back on, with a lot of shorthand. But if you go back to how long it took us to establish that language, productively or not, there really is a whole lot of communication necessary to work through the meaning of the particular framework of simulation.

But the very, very important point, and if I was in the mood to slam the table, I would on this, is that every assumption, every one of that long list that matters for the simulation is one that in less formal analysis is being made in a less aware and even more arbitrary way.

There's no shortcut around those assumptions. There's only whether you're using a framework that brings it clearly to mind what it is that we need to assume. It's a horrifying thought that implicitly, even in the world's greatest Guidelines, all of those assumptions are in essence being made in part based on convention, in part based on experience, but those very same areas that

need assumptions are the very same areas that come in simulation where it matters. There's no getting away from it.

Dennis, back to you on the question of whether other forms of empirical studies should have equal or even greater validity where they are informative. In these areas of the country where there's three stores, prices are lower than other areas of the country where there are only two stores, Office Depot and so forth, that's not exactly a simulation study, and it's a very clear way to organize the data.

But at the end of the day, someone is going to pop out of the woodwork and in some halfway credible sense, going to point to some efficiencies that go along with the accumulation of office superstores in different areas. And the only form of analysis that we know that enables an integrated approach to the assessment of direct price effects together with the other effects of the deal, purported efficiencies, to say nothing of R&D and dynamics, things that Dennis and I try to talk about in our own way, the only framework that begins to permit the integration of those different sides of the analysis is some sort of simulation.

So those are the two huge benefits of the simulation approach, and that's why I'm rooting for it

going forward. It allows integration, and it forces us to confront the assumptions that we need to be making in one form or another anyway.

MR. PATE: Dennis, I know you wanted to respond.

MR. CARLTON: I just have two points. First, I think Bobby is exactly right. If you read the Guidelines and you apply market definition and HHI analysis, you are doing a crude merger simulation. You are assuming a particular type of behavior Cournot and with constant returns to scale, and we probably all know that's not a very good assumption for many industries.

So the notion that you can define markets precisely and then do a better analysis than a merger simulation, I agree. That's entirely wrong. And therefore, merger simulation should be viewed as a more sophisticated way of doing the Guidelines. And in fact, it avoids drawing market definitions that we all know are just very, very crude and actually very hard to implement.

Having said that, the danger of merger simulation is that it, although I agree it can allow you to calculate efficiencies, it enables you to predict price increases only indirectly based on a lot of assumptions, and a more direct test, to take Bobby's

example, three stores versus two, can precisely answer the question you're worried about.

Now it doesn't answer the question about efficiencies. So then the question is, how do you answer that question? And that's a hard question, I agree. I think it's going to be hard in any event, and if you had a total efficiency standard, I think you would have enforcement difficulties trying to figure out what are the real efficiencies that are likely to occur.

And we know from people who have studied mergers that it's pretty hard to predict. And if you go back and ask those -- based on the predictions of the expected efficiencies, how many are achieved, you are really speculating. Now, I don't mind speculation, I suppose on the other hand it raises issues about enforcement.

But if you're using merger simulation to calculate efficiencies, that is the part of the merger simulation that is most in need of improvement. The errors you make when you estimate cost, marginal cost, by inverting a demand elasticity, is premised on the assumption you're making about competition. And if that's all the information you're using and you're not using any cost information, which people don't usually use, you're likely to get a very misleading estimate of

efficiencies.

So I'm just afraid that the most direct way of answering the question, is price going to go up, is something I don't want to discard. I agree simulation can help us, and I think it's a useful tool. I'm just worried I see it getting pushed out, pushing out these what I would call sometimes natural experiments that often allow you to precisely answer the question what happens if I have one less competitor.

MR. PATE: Dale?

MR. COLLINS: I'd like to echo a little bit what Dennis just said. I mean, as a practitioner, first of all, let me say that I think that simulation in the way it's been described here, I mean, what Dennis is talking about when he's talking about simulation, including the econometric estimation of the demand cross elasticities, I think this is a great tool, but it's a tool sort of still being promised as opposed to being delivered.

And I think if you ask yourself the question, what do you do with it today? Okay, and does it really have any impact at the margin in prosecutorial decision making? I think the answer to that question is largely no.

You can think of several things you could do

with merger simulation today. One is you could use it to predict just qualitatively whether or not the prices are likely to up. My guess is that that's a question that's not particularly interesting to ask of simulation modeling generally.

You probably already have a pretty good idea, you know, from other tools whether or not you think that the prices are going to go up. And I suspect, although I don't know this, that the number of times in which you sort of change your mind as a decision maker in a prosecutorial setting from either they weren't going up and now you've seen the simulation model and you decided they are, or they were going up and now you've seen the simulation model and you decide they're not going up, I think those cases are almost nonexistent, okay, at least today. It may not have been true a while ago, but I think it's true today.

So then the next question, if you don't need it to predict what the direction of the prices are, also recognizing to some extent if you're not packing the efficiencies into the model, I believe the models almost always predict that there will be a price increase, so you've got to worry about that a little bit.

So, what do you use it for? If it's not qualitative, then it goes in the direction that Dennis

was just talking about. Now, you're making it more quantitative. You want to make a more quantitative prediction about whether the prices are going up and by how much. And indeed, what you'd really like to do is trade it off against efficiencies.

And I think there, too, the models right now, sort of the development of the science, if you will, and the informational requirements that have to be met in order to do actually pretty good modeling, are just so demanding. Because you usually don't get very good results. And "very good" in the sense that it doesn't change prosecutorial decision maker's minds about what's going on. They're actually making their decision on other bases.

They're getting some comfort from the fact that the simulation model is coming out the same way, but the thing is, my point is, I don't believe that the decision making would change if you just eliminated simulation, you know, from the investigation today.

Now, I think it might change in the future, and that's why I'm a big proponent in seeing a lot more work done on this. But, as I said, I just don't think it's having much of an impact today.

MR. PATE: Dan?

MR. RUBINFELD: I'm not going to go over

everything that was said before. I'll just see whether I can add some new thoughts to what was said.

First of all, compared to the work that's been done in coordinated effects, I think the science of unilateral effects is further along. It's still got a long way to go, as was suggested, and we certainly should be careful about being too quick to dispense with it. I think we ought to pursue some of the kinds of problems people have been talking about here today, and I think 10 years from now we'll see techniques for doing demand estimation and simulation that are even more sophisticated than what we're seeing now.

We'll see more and more people being aware and sensitive to some of the problems we've talked about, other problems, such as what to do when you're looking at a wholesale merger but you're relying on retail data and things of that sort. But the fact is, we're doing well.

The other area I think interesting work is going on, and I happen to be interested in it, responds to Dennis's concern that we seem to rely heavily on estimating costs from demand elasticities. I've always had the view that we ought to actually be going both ways, so I've been actually working hard on thinking about how to look at accounting data on cost and to use that to infer elasticities and then to figure out what's

going on when the two don't seem to gel, which is often the case, as Dennis suggested. So you really can go both ways. There's interesting work to do there.

The other thing is that my work has suggested to me, perhaps surprisingly, that when markets are not totally differentiated and they're not really unusually situated products, that market share is actually a reasonable predictor of the likely price effects. This may support what Dale is saying. Maybe you need to go through this exercise in certain kinds of markets because the Herfendahls matter. I wonder if you remember that later when we talk about the value of concentration numbers. I think they actually do give you a first-order prediction even in unilateral effects cases.

Furthermore, I think there's interesting work to do in thinking about how merger simulation can be used to think about the likely effect of divestitures, an area where I think we have not done much work. There's a lot of potential. And it is possible with the simulation framework to actually do hypothetical simulations as to the likely effect of different divestitures, and that's an area I think there's great promise in.

But, the science has still got a long way to go.

A couple of other quick points. First, I want

to reiterate, I think, what Bobby said, or maybe it was Dennis or both. No one of us who does the technical side of this work has ever believed I don't think that this stuff works on its own; that you should rely entirely on a simulation. It's a framework for analysis. You really have to couple it with information that comes from the documents, from the record and make sure that the two really make sense.

And I would never want to testify myself about a simulation unless I was convinced I had seen enough of the record to make me believe this was something to rely on. I have seen a number of studies which don't do that, and I wouldn't believe them just like everybody wouldn't believe them.

And finally, I guess I wanted to point out that we are in the process, and I think properly so of trying to do a evaluation of the effectiveness of simulation studies, and there were folks who have suggested, and we assume the agencies are doing that now, that we ought to go back and kind of look at some prior mergers and see how well these techniques have worked in the past. I think that's excellent work. We ought to think creatively about how to do that.

But I do want to give a warning ahead of time, because I see a possible problem down the road. When

you're doing forecasting generally, and I can tell you about this, because I write about how to do it at least more than I do it. It's easier to explain as a professor how to do things than it is to do things.

If you actually at -- if you look at, say, my textbook on forecasting and you look at macro forecasting, and you actually ask yourself, when errors are made in forecasting, what's the source of the errors? And the source can come from at least three different components. It could come because the model -- the framework you're using -- is the wrong one. It could come because of the inputs to the model, what we economists call the exogenous or predictive variables, turn out to be badly forecasted, or it could be just some random event, act of God, whatever, 9/11, something like that, that no one could possibly hope to explain.

With macro models, if you really talk to the people who do this and they look back, two-thirds roughly of the errors that are made in forecasts come not from the model itself but from these factors, the predictions of what goes into the model and acts of God and so on.

We've been finding the same thing with merger simulation. No one expects merger simulation to be very accurate in predicting all effects of a merger, because too many other things are going to be going on at the

same time.

So I encourage analysts when doing this evaluation to be careful when the merger simulation doesn't work well to tease out whether that's the framework, whether it's because in fact we were assuming Bertrand behavior and in fact the world turned into a collusive world that we didn't predict, or is it the fact that some of the inputs, some of the cost numbers turned out to be wrong.

I think we're likely otherwise to be too critical of merger simulation. We shouldn't expect anything of these models beyond what a reasonable person could expect.

MR. PATE: Okay. Good. I'd like to move to what I think was the panelists' favorite question in the little pre-meeting, which is this: What merger enforcement decisions -- and I'll include decisions to challenge or decisions not to challenge a merger, and include agency decisions and court cases, and I won't limit this to present company -- which of these decisions would you point out is the best or the worst of the past, well, let's just say in recent years without defining it any more specifically, and why do you think those were particularly good or bad decisions? Does anybody want to take an opening shot at that? Go ahead.

MR. BAKER: My favorite is Staples I think. That's good.

(Laughter.)

Maybe, Greg, in your role, you have favorite things that are bad. But when I say "favorite" -- of course, I worked on this, but, as Greg is essentially pointing out, it reinforced unilateral effects analysis, although the opinion reached the unilateral effects by defining a submarket rather than directly through competitive effects analysis, I understand it as substantively the same thing as a unilateral effects case, it emphasized the importance of empirical evidence on pricing.

The court mainly relied really on the documents about it, although there was extensive econometric analysis confirming what the documents had said, that was important in the agency decision making at the very least. It endorsed the Merger Guidelines approach to entry and efficiencies. So all of that was in play at the time to some extent at least, and this court came through in a way that got everyone's attention to confirm these various initiatives of the agencies about empirical work, unilateral effects, the entry and efficiency sections of the Guidelines.

And it gave the FTC credibility at the time in

litigating contested mergers. And plus I got to work, you know, closely with, what did you call him, Hew? The best in America? What's not to like?

MR. PATE: It sounds pretty good. I never dreamt anybody would start out with a favorite that they thought was good, but that's one way to do it. Who else? Jim?

MR. LOFTIS: Well, I'll take the other side of that. A favorite that I think was unhelpful would be the baby foods case with the reemergence of interest in concentration and what it really means. There I think we have an example of the use of concentration, and particularly I'll refer again to the agency brief that argued that an HHI of 510 presumptively entitled it to an injunction which, of course, would end most any transaction.

I think that that was a very --

MR. BAER: You said this before. Did you mean the delta?

MR. LOFTIS: The delta, yes. I think that was a decidedly unhelpful move, Bill.

MR. PATE: Jim?

MR. RILL: I'll go good and bad, but they'll be different cases.

(Laughter.)

I think some of the vertical cases that were brought in the early part of the '90s were particularly unhelpful, both from the standpoint of their rationale and the standpoint of the relief, I think that the DOJ, the Rube Goldberg kind of structures that followed ATT/McCaw and BT/MCI were monstrously complex, and I think just to be equal on the other side, some of the firewall cases that came out of the FTC early on -- Merck, Medco and its predecessor, the PCS.

MR. COLLINS: The only reason why I was shaking my head was Merck/Medco actually came first and got through without a --

MR. RILL: Well, it got through without it, and then they tagged on a firewall to Merck/Medco after the PCS case, so Merck/Medco followed PCS in technique.

Good, I think I want to pick the cruise lines decision for a variety of reasons -- for the comprehensiveness of the analysis, for the competitive effects review, for the relegation of structure in the proper role.

I don't want to get too close into whether or not airplanes or hotels were in the relevant market, but they were certainly considered as part of competitive effects, and I think that was an appropriate consideration, and I think the transparency that the

Commission majority exhibited in describing the basis for that decision was a real step forward towards an explanation of merger review.

MR. PATE: Bill?

MR. BAER: Dale, did you want to go --

MR. COLLINS: No, that's fine.

MR. BAER: The category of cases that I would cite as failures, as bad outcomes, as favorite bad things, is the inability of the government to win a hospital merger case. You know, I think at the end of the day, some of the hospital consolidation we've seen across the country has in fact had serious anticompetitive effects, and the inability of the government, both the Department of Justice and the FTC, to convince local district court judges that in fact there really are potentially bad outcomes here, has basically almost created an exemption to the Section 7 for a major part of the health care industry, and I think that's unfortunate.

MR. PATE: Dale, you wanted to comment?

MR. COLLINS: Yes. I'm not -- my judgment on what, if you will, a really good case was, unlike, I think, what most people, you know, have said here, which went to sort of what the outcome was or the analytical tools that were employed in order to reach the outcome,

I'm going to step back. I think the case is Baker-Hughes.

And the reason why I think it's Baker-Hughes is Baker-Hughes made the analytical framework for merger analysis really clear in the following sense. It said that there was a presumption. The Supreme Court had said it before, but, it made clear that there was a presumption -- that the plaintiff could basically on the basis of market shares have a presumption that satisfied their burden of establishing a prima facie case.

It also put the burden then in that particular case on the defendant to go forward with evidence in rebuttal, and in that case, it happened to do with entry. But it was only the burden of going forward. Baker-Hughes makes absolutely clear that the burden of persuasion on the question of whether or not there's an anticompetitive effect on the deal always rests with the plaintiff. And I think that that is one of the most important things that's come out, you know, in modern merger law, which I'll start with like 1974.

I think that a lot of the debates that we have generally, I think a lot of the discussions on the panels that have been up here over the last couple of days, if we in effect join the issue much better on who bears the burden of proof, and in particular, that the plaintiff

always bears the burden of persuasion, it makes a lot of this analysis a lot clearer.

It tells you, for example, if you're going to have an entry defense, you know, who's got to go forward with the evidence but who bears the burden of persuasion.

More importantly, if you're going on efficiencies, I mean, it tells you a lot there too. I think it's a simple extension from the Baker-Hughes analysis of the burdens on a quote "entry defense," which is really a negative defense, not an affirmative defense, into other things like efficiencies.

I think it was a great case as far as the allocations of the burdens of proof are concerned, and you just don't see it very much in the case law.

MR. PATE: Well, you seem to have a lot of your fellow panelists nodding with what you've had to say about Baker-Hughes. Are there other cases? All right, Bobby, go ahead.

MR. WILLIG: A couple of my favorites from the methodological point of view. First, American Electric Power buying CSW, Central and Southwest. Two big electric utilities. You know, not front page stuff, not all that exciting. Who cares? This is not like baby food or something that we consumers really understand a little bit, if you've been parenting.

But rather this was a case where the utilities were quite separated geographically, but nevertheless they were interconnected electrically. And the question was whether having the generation decisions were coordinated between the two sets of sources of power after the merger, would that yield new opportunities to increase market power? And there was no way anybody could just intuit that answer. Various technologists thought they could, but never in a persuasive way, certainly not to me and not to the agency either.

And so the agency and the parties worked together over a long span of time, step by step, to lay out an analytic framework using appropriate models of simulation and the like, but always with a mutual concurrence about the appropriateness of the tool, and then marching along with new questions being raised, and then working through the answers to those questions in a complete bilaterally transparent way.

I liked it because I was working for the parties and I came out for the deal. So it was a happy ending as far as everybody was concerned, I think.

But the process to me was a real role model for other cases where the analytics of the econometrics or the simulation are difficult, why can't we kind of work together along the lines of that same example?

Another case that I always just love to talk about in class is Microsoft and Intuit. Remember that? Microsoft had Microsoft Money. Intuit has Quicken. And they sought to merge. And the agency hated Microsoft so much, or so it appeared from the outside view, that, of course, they weren't going to be allowed to merge with anybody. That was sort of the body language. And they were enormously overlapping products.

But right away Microsoft offered to divest the Money code to some other major software house. And so it wasn't an overlap of code or of market share anymore. What was left to the case was a very, very strong overlap in what I like to call, and I think the government used these words, platforms for competitive advantage in the relevant market for personal financial software.

Intuit -- Quicken -- had a huge installed base of happy users. Microsoft had all the advantages that one understands Microsoft to have in any area of software dealing with the desktop, and the Department judged that these were the two most important platforms for competitive advantage in the relevant market. They should not be allowed to combine because of the market power that it would create. No concentration measure. No counting of beans, how many lines of code had been sold to whomever; just a direct assessment of competitive

advantage.

And I'm not sure that was the right answer. There's lots of other competing platforms for competitive advantage in that space that have emerged since. I don't know if it was a good decision or not, but I love the analytic framework, and I would recommend it.

MR. PATE: Dale, I'm not sure you're buying all of this.

MR. COLLINS: That's not the only legal framework, okay. At least from the outside. I think the way the case is best explained, and certainly the way I think that all the practitioners read it was, Microsoft did a preemptive divestiture of Microsoft Money to a company whose CEO said they weren't going to run it as a product, okay. So in effect what they did was they just killed the product that created the overlap. And that's what killed the deal.

That coupled with, if you read the complaint, there are just enormously great statements that if you ever teach a class, you want to read to your students, particularly if you teach MBA students, on how not to write memos.

(Laughter.)

There are, as I said, they're just unbelievable statements that the government could quote. So maybe

that's the way the government inside, you know, viewed Microsoft. If it did, they created an extremely complicated theory on what was an extremely easy case on the facts.

MR. PATE: Dennis, do you want to comment on the best and worse case question?

MR. CARLTON: Yes. Let me just sort of echo one thing Bobby said, and that is it actually fits into an earlier question. The transparency that's used at the agencies now, I think, is really a credit to them. And I've been involved in several mergers in which the concentration numbers looked terrible, but you present them some data, you do some econometrics and give them the data and then you collaborate actually in a process, and if you're right, they'll recognize it, and they'll understand the issue.

So, you know, there are smart guys at the agencies, and when you can collaborate and get a merger through, in particular I'm thinking of some mergers in the movie industry, I think it works great. So that's to their credit.

I would say the one case that's always stuck in my mind is a mistake in part because it introduced a new concept was the GM/ZF case. That was a case brought in the early '90s. There was a proposed merger between ZF,

which is a German company, and General Motors transmission business, and one of the allegations in that case was that it would concentrate innovation markets. I believe this was one of the first times the concept of innovation markets had been used.

I thought it was a bad concept then and subsequently I've convinced myself it's a bad concept. It's very hard to implement what you mean by the resources that can be brought to bear to innovate in an industry. And as a general concept, I think, except maybe in some industries like pharmaceuticals where there's a pipeline and you can predict exactly what's coming along over time, in most industries, it's very hard to make predictions where technological innovations are going to come from.

So as a general principle, I thought it was bad. As a specific example, I've stayed in contact with General Motors. They still own this transmission business. And anytime I'm going to talk about innovation markets or I'm going to see either Steve Sunshine or Rich Gilbert, who played a large role in developing the concept, I call my friends at General Motors. And I said, well, have you innovated like the Justice Department was suggesting you would if there weren't a transaction? And the answer always is no. So, you know,

10 years later, about 10 years later, we haven't gotten the benefits of innovation. We've lost the benefits of the efficiencies that I think many people recognized would occur. So I think that I would put high on my list of cases that I wish hadn't been brought.

MR. PATE: Okay. Well, I'm going to follow up on both transparency and innovation markets. Dan, do you have a best and worst case you want to point out?

MR. RUBINFELD: It's not quite a best and worst case. But I realize in listening to the group that sometimes a series of cases come along that create frustration on one's part, whether you're inside or outside. And I had some of Bill's similar frustration about hospital mergers, and I think Bill's characterization was right there.

Another area that's similar to me is the area of acquisitions involving journals. If you look over time in the last 10 or 15 years, the prices of academic journals have gone up on the order of 10 or 15 percent a year. And my belief is that at least some explanation for that has been the acquisitions that occurred, several of which occurred on my watch.

The problem that we have in looking at these kinds of acquisitions is, we tend in my view to scrutinize it too much. We want to go through the usual

sort of market definition, competitive theory, and we end up defining markets extremely narrowly. No book competes or no journal competes with any other journal, and it's very hard to conclude that any merger would be a problem. Yet the fact is that there have been extremely high increase in prices, and my belief personally is that it has a lot to do with the fact that the major concentrated ownership publishers have had really bargaining power with respect to university libraries because demand for products are highly inelastic.

And none of that is really reflected as well as I think it should be in the analysis. And the agencies, while getting divestitures in some cases, I think have not been nearly as aggressive as they should have been.

Sorry, Dale.

MR. COLLINS: What can I say? I mean, I think the best case -- I've talked about one -- but I think the best cases are all the ones I got through.

(Laughter.)

MR. PATE: Yeah, I think we're getting a little of that around the panel. Let me ask -- turn to transparency and ask about that. I'd be curious to get reactions about whether the agencies should be more transparent about what they do and how. I know it's easy for you, particularly in the businesses you're all in, to

say, yes, of course, you should be much more transparent. But some of you have been in positions in these agencies before, so I hope you'll give a thoughtful answer that takes into account some of those interests.

And also, we could expand that maybe to talk about the Guidelines question -- divergence of practice from the Guidelines. Some folks have suggested that it's not a great use of agency resources to revise the Guidelines. It's very time consuming and that the people who really do this know how it's really done, and there isn't a lot of value. There's a countervailing view that in fact the agencies are obligated to try to make the best expression they can about what really goes on.

And I'd be curious to get your thoughts on both of those aspects of transparency, or others. Jim?

MR. RILL: Thanks for the lead. Those of us who have sat there who have not done nearly so well as those of you who sit there now. It's a continuing process.

One of the things that concerned me going in was the need to be more transparent, to explain more what we did and what we refrained from doing. And Bobby and I, and Judy Whalley and others attempted to work out ways where we might do that. You'll recall trying to explain the accounting merger, the non-challenge of the 8 to 6,

and the non-challenge of the tire merger.

You run into a couple of problems in doing it which I think are fairly obvious. One is confidentiality restrictions on information that can be divulged. The parties aren't thrilled about the notion even if they've been given a pass about having their information spread on the record.

The other is a reason with less rectitude, and that is, I think, an institutional fear of being boxed in. We let this merger take a pass because of X. The next 10 parties coming into your office have an X merger.

(Laughter.)

Or at least one so labeled. That's not a very good reason not to be transparent. I think the Commission has made really good strides, starting with some of the work that Bill Baer did, maybe before that, but certainly starting with some of the work that Bill Baer did in pharmaceuticals and in, I think, grass at one time. That's the stuff you grow on greens.

I would have to say the Division always sort of had a not self-imposed, but extrinsically imposed leg up because it had to do Toney Act statements in settlements at least which had to pass muster sometimes with a rubber stamp and sometimes not so much with a rubber stamp, though. And one never knew ex ante whether you were

going to get a challenge or not and then had to explain yourself pretty thoroughly.

I think in a nonmerger case, one of the most thorough explanations of settlements I saw was in the ATP, Airline Tariff Publishing settlement, which went through a lot of explanation.

The work needs to go forward, I think. You had a second question, though, and I'll comment on it briefly, and that was?

MR. PATE: The Guidelines and transparency as it relates to the Guidelines.

MR. RILL: Yeah. I think there may be a point there. I'm not so emphatic about it as Dale is. I think that if I had to point to one issue the way I think that it's somewhat highlighted by the recent FTC report, and that may be an ex-guideline reliance on customer complaints.

Now, customer complaints, of course, can relate to the Guidelines, but customer complaints can sometimes relate to totally non-guideline concerns that customers might raise -- customers, not competitors now -- customers might raise in challenging the merger. And one only hopes that the agencies can take a look at those statements and fit them into what's truly a competitive analysis and not engage in a numbers count. So I would

say when you look at the FTC report, one hopes that the word "serious complaints" and "substantial complaints" really mean serious and substantial complaints.

MR. PATE: Jim Loftis?

MR. LOFTIS: We talk about transparency with kind of an aura of apple pie and goodness to it, which deservedly to an extent it has. But largely the reason we are here are clients. And by and large, clients hate transparency as to their deals. They're interested in transparency only as to other people's deals. And the only thing worse than transparency is the notion of a look back.

(Laughter.)

So, you know, I think we've got it just about right.

MR. PATE: Okay. Dale?

MR. COLLINS: Two points on transparency. And both a little bit definitional. I think there are two kinds of transparency. The first one is, if you will, the after-the-fact transparency. The agency is explaining what they did or, whether or not they're actually really capturing everything they did is a different point, but at least there's a coherent story about why they made a prosecutorial decision that they made. That's one kind.

I think there's been great strides, again, as Jim has pointed out, in that aspect. I think where the record is a lot more mixed, and to me as practitioner, this is pretty much what Jim was saying, too. For those of us who represent clients, the transparency we're interested in more than anything else is the transparency that goes on in the course of an investigation.

And there are some people within the staff, and this is true on both agencies, that are, if you will, extremely transparent. They'll come up to you and they'll say almost from the beginning, these are the theories of anticompetitive harm we're testing. If you've got an argument that says this theory is not a viable theory, we want to hear it. We may believe the argument, we may not, but we're going to keep in front of you what our theories are and give you the opportunity to address them.

I've got one case, for example. I won't tell you quite what the time frame is. We've been in investigation for two-and-a-half years. We still don't know the theory of anticompetitive harm that the staff is testing, okay. We've got another one where the staff didn't start to reveal what they were testing as far as theories of anticompetitive harm in any explicit sense, until what, five months after we complied with the second

request.

That was the first time we ever heard from them what the theories they were testing. Of course, we're sitting back doing everything we possibly can to cook up what are the theories they could possibly be testing, coming up with all sorts of theories, and tossing in arguments about, you know, you can't be testing this theory, because here are the five reasons why it's wrong.

I think what really needs to be done on both agencies' part is that the transparency in the course of the investigation needs to be improved substantially. I think there's an obligation, and let me just real quick on this -- it's an obligation that goes both ways. And it's in the following sense. The senior officials in the agency should be instructing the staff, they need to be more transparent with the parties from the beginning on the theories of anticompetitive harm they're testing. That's one way.

The way that it goes back is, the senior officials should tell the parties, do not come in here and tell me what the staff was, in fact, telling you as their sort of working hypothesis of anticompetitive harm early in the investigation. I don't want to hear it, all right. The only one I want to hear is the one that's being addressed at the end of the investigation. And I

think the parties have got to learn that lesson, that they can't go to the front office and basically be telling the front office, well, the staff was telling me this, you know, at an early part in the investigation, and now they've changed their mind and we've been prejudiced.

MR. PATE: Well, it seems like a bad idea for me to follow up, but I'm going to do it anyway. When Charles James came in a couple of years ago, we began working at the division on a merger process improvement initiative.

The Trade Commission has been working at that, so I'll give you a free shot. Are we making any improvements? And before you answer, I will say that I think it's been my observation at least that Charles' comment that it takes two to tango has not been taken to heart universally, and we certainly continue to see a number of parties who don't reciprocate the staff's willingness to say here's the theory. We'd like you to provide the following information promptly to test it. But with that defensive caveat, what's your experience?

MR. COLLINS: Let everybody else talk on this. My experience is, I've seen no changes. I think that the people who were pretty good before Charles made his statements about being forthcoming on the theories of

anticompetitive harm that they were testing -- they continued to be good. The ones who weren't good, you know, aren't good today.

I think there are lots of institutional reasons for that, but I think it is a serious problem.

As far as the parties are concerned, I couldn't agree with you more. I mean, I think that there are some counsel who come in and say, look, what we want to do from day one is join the issue. Now, there are some of us who believe that that's actually very much in our advantage to do that.

There are other people who believe, and I've had them to talk to me -- I sort of fall into the first category, as you might imagine -- who come in and say -- and we have these huge fights in the beginning of a deal, a joint defense of a deal. And they say, look: We don't want to talk to the agencies at all. We want to wait until we get to the deputies meeting is the first time we're really going to make a defense of the transaction.

I think that's crazy, personally. But there are people out there who believe that.

MR. PATE: So you rely on Tony Soprano for saying most business problems are people problems?

(Laughter.)

MR. PATE: Other comments on transparency?

Anybody else who's had experience recently? Bill?

MR. BAER: I think it is marginally better in terms of that individual case process, and even the people who tended to be very closed off are at least trying, I think, to be a little more open. But it still is a widely varying experience one has in terms of the quality and the detail and the timing, as Dale says.

But I want to go back to the first kind of transparency. The information that the agency put out in December, the information that the FTC put out last week or the week before, is extraordinarily helpful in terms of counseling. You can now take a look at these grids and provide clients some sense of what the odds are, that if you properly define the market and your market shares are X or Y, based on the FTC data. You review the documents, and if they suggest a view of the market that's different than the one you need to win, that that's going to hurt you, and if you really have some doubts about whether the customers are going to line up and support this deal, you can help people make more informed front-end decisions about whether or not to go forward. And I think that's helpful to us in advising businesses on where to go.

To go just real quickly to your question about merger Guidelines, it sounds like -- whether they need to

be changed, updated -- I think those of us who endorse transparency have to think long and hard about whether supporting the retention of Guidelines that have numerical standards in there that have no relation to current enforcement postures is a good thing.

To have a document out there that is a stated guideline as to merger enforcement that doesn't come close to reflecting over the last 10 or 12 years merger enforcement experience, is something that I think on balance you ought not to support.

You could raise the safe harbor to 12 - 1400, and get rid of the notion that 100 point increase above 1,800 is presumptively unlawful, that's just not right. I mean, there are little changes you could make that could make that document a little more current. You could also consider, and I know Jim and Bobby and Jon, when they were there, ran out of time to do this, whether or not we want to update guidance on vertical mergers as well -- a tough analytical concept and maybe you bite into more than you want to chew on that issue.

But I do think trying to get the numbers closer to where enforcement posture really is, is probably a net benefit and not a hard thing to do.

MR. PATE: Jonathan?

MR. BAKER: I have an observation on this in

terms of the analytic framework question, which is the Guidelines point. On the whole, I think the Guidelines are still useful in helping explain the theory, the analytic process the agency goes through, the theories that they pursue, the kind of evidence that might be relevant.

It's, of course, important for good government reasons for agencies to advise all of those on the outside about various sorts of twists and turns and how they're thinking about matters. For example, some of what I think it was Jim who was pointing out, customer complaints or competitor complaints and how that's being thought of today. That's appropriate for speeches, it seems to me, by agency heads.

Revising the Guidelines is a big deal. It's hard. It's hard on the agencies. You've got to be really careful about how you say everything, and I don't object to good government improvements, but if you actually look back at the history of Guidelines revisions, it's largely not been good government improvements as the motive for revising. If you're revising it for another reason anyway, you'll make your tweaks of various things like the HHI standards.

But the 1982 Guidelines, what those were all about was how do we take into account what the new kind of

Chicago school thinking about antitrust in the context of merger analysis? It was already transforming antitrust in the courts and the agencies had to understand what that meant for merger analysis. That was the motive, perfectly good motive, for revising the Guidelines.

The 1984 Guidelines responded to a big fuss about some steel mergers that was a very hot political issue at the time about the role of global competition where there was an unusual spat between members of the cabinet in the Reagan Administration.

VOICE: I thought it was about the role of Mac Baldridge.

MR. BAKER: Well, yes. But it was -- but that's a good reason to take another look at geographic market definition the way that it had been.

The 1992 Guidelines essentially -- and Jim's not going to like this -- but essentially took into account the reworking of industrial organization of microeconomics around game theory and oligopoly theory and took what insights we could get from that and imported those into the Guidelines, along with a host of other good government improvements along the way.

The 1997 revisions were prompted by, in significant part, by the hearings that the FTC did about high tech and global competition and the efficiencies

analyses that had become important in lots of ways and were growing in importance in antitrust thinking, and it was time to kind of address in Guidelines.

If there's a comparable motive for revising Guidelines now, it seems to me, and I think it's something that Bobby hinted at earlier, it has to do with innovation competition. There's been a lot of discussion about innovation competition, particularly the recent hearings of the two agencies. There are disputes about innovation markets that Dennis has been talking about today. We could talk in detail about how we think about them now, but we don't have good analytic frameworks worked out. I'm not sure whether we really understand the analysis well enough to do that.

But that's the area where if there's a good reason to revise the Guidelines comparable to what we've seen in the past, that would be the motive. And then while you're doing that, you could think about Bill's HHI tweaks and the like.

MR. PATE: Dale, you had a response?

MR. COLLINS: I think this follows on what Jon was saying, and it goes to Bill's point about the HHI tweaks, and that is, to the extent that what you're interested in doing is counseling your clients, okay. I think now we've got something that's more valuable, at

least as far as the front section of the Guidelines, and that's the release of the data.

I think the best way to look at the Guidelines, the front end of the Guidelines, is that this is purely just a screen. And maybe there was, in retrospect, an unfortunate choice of words on safe harbors and things like that, but it's really just, you know, are we going to now make the decision to invest some significant prosecutorial resources into investigating the transaction?

My personal view is, and it's not just because I've got a couple of kids that are going to college, is that, you know, you'd have a relatively low screen on that. But then you don't go to the clients and tell them that, if you don't come under what is colloquially called the safe harbors, right, then you guys are dead. I mean, that's malpractice, okay, because a lot of the deals don't pass the safe harbors, and most of them get through without any trouble.

But it's this new data that'll really help you on that. And if I could just ask you, Hew, to think about one thing with respect to the release of the data. The way the data is organized in part, it tells you, you know, where there was an enforcement -- the number of enforcement actions within a cell in a matrix and the

number of things which were closed. The stuff that's closed is probably pretty confidential.

MR. PATE: You mean the FTC data?

MR. COLLINS: The FTC data. Excuse me. And the real question, I think, what I would like to see is, which should be a matter of public record, and it's just a matter of matching it up, is on the enforcement actions which were public, which of the things -- when I see a number in a cell that there were three cases, okay, or two or whatever it was, when there was a challenge when it was the HHI, the post-merger HHI was like 1,800 or 1,900 and there was a change between zero and 99 and there's actually some positive enforcement cases there, I would love to know what they were. And that should be a matter of public record and I'd love to see it disclosed.

MR. PATE: Dennis, I think you were next.

MR. CARLTON: Let me just briefly address the two issues. On the first, on the Guidelines, I think the Guidelines are pretty broad right now to encompass sort of new theories and their implementation.

In terms of the numerical Guidelines, I actually think they serve a very good purpose from the point of view of good government in letting people know what constraints are placed on government so that if someone comes up with some crazy theory of

anticompetitive harm that's purely theoretical, they have some protection. I think that's very important. Assistant professors, even full professors, get paid to think up complicated theories that get published. But the ratio of our theories to empirical testing is probably too high. And you want some protection against someone doing that.

Having said that, I've always found it very interesting, and I did work on the previous Guidelines in '92, that the empirical support for these breakpoints is surprisingly weak, and you'd think that everybody would be wanting to write a dissertation on where are the real breakpoints and where do they jump, and are there jumps? But there is virtually no literature on that. I mean, I've searched to try and find published articles that people frequently cite for this, and it's pretty hard to find any such evidence.

On the other hand, I do think it's a protection against unconstrained government action.

On transparency, the only thing I would say is this. Obviously the lawyers have a particular perspective, but as an economist going in, one thing I'd ask you to think about is the following. I've certainly noticed increased transparency over the last several years.

One of the things that often makes my client sometimes nervous, but also makes the DOJ or FTC nervous is when I say, well, if you have any questions, just give me a call. You know, sometimes I often check it with my client, and I'll say it's really in our interest. It is really in our interest for the staff to know exactly what we're doing. And I can answer questions to an economist.

But then if the FTC or DOJ says that's great, we're going to have an army of lawyers on the call when the economist calls you, my clients, say oh, no. No, no, we're going to have our army of lawyers. And then you have an army of lawyers saying that's not a good question, that is a good question. So if you're really interested in transparency, I'm always happy to speak with the economists at the FTC and DOJ, and I think most of them would be happy to speak to me. But sometimes I sense they're very nervous. And you might think about how you want to deal with that.

MR. PATE: Well, I think those of us who are responsible for cases that go to court are all in favor of economist-to-economist dialogue within reason.

(Laughter.)

MR. PATE: Jim, a couple of quick points.

MR. LOFTIS: Just a quick point on transparency in the decision making process. It is curious, and I'm

not sure what it tells us, but it's curious that there is an enormous amount of transparency into the decision making process on both sides where the industry and the clients that are proposing a transaction are repeat users of the system.

If you've been a proponent of defense industry mergers you've been going steady with the same folks at your agency, Hew, you know, for the last half a dozen years, and it almost becomes like the story of the comedians who would exchange jokes by saying number two.

(Laughter.)

I guess what it tells me is that transparency works. There's no reason not to have that kind of visibility.

MR. PATE: Dan, did you want to make a comment?

MR. RUBINFELD: A couple of comments. On transparency, I recently shared a very nice experience with the FTC staff on a merger where they were very transparent and so was I, but I have to say -- I hope my client doesn't get upset at this -- that the hardest part of the battle was convincing my client to let me be transparent.

So once I had achieved that and I could talk seriously with the staff, it was actually easier going. So it's a problem on both sides. And in this particular

case, convincing the clients to let me talk without an army of lawyers watching every word I said was the hardest part of the case. I probably didn't tell you folks that before.

But going back to the Guidelines, having been involved a bit in the joint venture Guidelines and having watched the 1997 efficiency improvements close hand, I actually don't think it's a good investment to try to actually write new Guidelines. I think they are great structure for thinking about mergers.

But if I were going to change the Guidelines or at least change some of the ways I thought about mergers, here are a couple of quick thoughts that run through my mind. One is -- with apologies to Bobby and Jim -- I don't see any value of the 35 percent unilateral effects harbor. I think if you're over 35 percent, the two firms that are closest competitors are over 35 percent, you're going to generate significant anticompetitive effects in almost any merger simulation anyway. And the 35 percent number creates weird incentives for parties.

Secondly, I agree generally about the point about the delta, but the states are not always on top of the common law as we are here in Washington. I cite as an example, with prejudice because I was involved, the Kraft General Foods case brought by the State of New York

where the delta by my calculation, was 96. The state thought it was 102, and that led to a huge battle.

(Laughter.)

And it just seemed weird to me because at the same time I could point to 10 mergers with deltas of 500 which were going through the agencies very easily, and it was like a strange world.

And finally -- this is really a separate point. If I were sort of thinking about new areas other than dynamic efficiencies and innovation, I would think a new area to think about, you know, not really writing Guidelines, but developing themes, is the area of corporate governance. We're seeing more and more deals that involve partial equity acquisitions, other kinds of complex forms of governance relations.

The staff in the agencies are trained as attorneys or economists. Most of the internal folks and most of the economists in this business don't know a lot about the economics of corporate governance. There's a huge literature on that that's relevant, and I know the agencies, at least since I was there -- both agencies have been thinking hard about it, and I really think it's an important area to do more work in.

If I were advising hiring more staff, I'd say think about hiring some finance professors or some

lawyers who do corporate law and get them involved in this. Because right now we have some very simple rules that we use to think about governance, and I think the rules are almost always wrong.

MR. PATE: Bobby, last word before a short break.

MR. WILLING: Thank you. On numerical portions of the Guidelines, it strikes me as healthy to have a boundary to the safe harbor of 1,000, but the de facto boundary be 1,200. I mean, it's nice to have a little leeway there. And I think if in some attempt at excessive transparency the explicit boundary were raised to 1,200, the expectation would be naturally that the de factor boundary would move up to 1,400 inappropriately.

So I think in that respect, the numbers that have been published lately really are consistent with the published Guidelines.

On transparency, and we can come back to this after the break because this may be worth talking about with counsel, the boundary to transparency that I and my colleagues have repeatedly run into with the economists with respect to data handling, econometrics and simulation, has been the litigation needs of the agency. It's the big bugaboo. It's the big bear which the lawyers are always using as their hammer to alleviate

their own fears and concerns, which may or may not be warranted from my point of view. I don't really understand the litigation side from counsel's perspective.

But all this good talk about transparency runs into litigation concerns quite routinely all the time on the hot case list, which is where it matters the most. So I would love to hear counsel with inside experience speak to that after the break perhaps.

MR. PATE: Okay. We'll pick up on that, and then shortly after the break, I also want to get to the question of these grids, the data that's been released and what surprises, if any, are in the data or what conclusions do you think can be drawn from the data. We'll talk about innovation markets, transparency, maybe a little bit about customer complaints.

So let's take approximately 10 minutes and reconvene at 3:20.

(A brief recess was taken.)

MR. PATE: I want to follow up with something that Dan and Bobby commented on -- Lawyers as an impediment to good, honest economist-to-economist communication.

(Laughter.)

And I guess the better question might be: would

we be better off if we just handed antitrust over to the economists and got the lawyers out of the room? And a different way of asking that, though, is how realistic is any of that, given the fact that we have a court system which is ultimately where the agencies are going to have to go either to enforce in the first instance or have an enforcement decision upheld. What is the future of the economist/lawyer balance of power in antitrust?

And I know, Jonathan, you're both. Maybe I can start with you on that. Others too.

MR. BAKER: Thank you. My experience is that when you're talking about individual cases and you ask what's really important, sort of the economists or the lawyers, and particularly in driving an agency decision, that's really where the lawyers are important. Case by case, the lawyers are thinking about evidentiary questions, about burdens of proof. They're negotiating details of divestitures. The lawyers are really, it seems to me, using the economists to help shape thinking. But a lot of the case-by-case work is really driven by the lawyers.

But if you think about how antitrust has changed decade by decade, that's really all about economists. It's economic ideas, economic thinking, new approaches, new tools, new perspectives that shape how

antitrust changes in the long run.

So I think that in some sense antitrust lawyers are ready to hand it over to the economists, you know, from the long-term point of view. But we give it back to you every day.

(Laughter.)

MR. PATE: Maybe. Lewis Powell wasn't an economist I guess. Jim, were you first?

MR. LOFTIS: Well, to tag onto that, what in turn drives the lawyers are the clients. And what the clients are interested in is getting the deal done, which means either through the agency process or through the court process. And as long as that's the determining factor, then the lawyers are going to have the predominant say.

But I certainly would agree with the observation that we are increasingly being ruled or at least influenced by economists.

MR. PATE: Dale? All the lawyers had their hands up on this one.

(Laughter.)

MR. COLLINS: I had a couple of things. One, I think that there should be ways for the economists to talk to one another that don't give rise to a lot of problems later on, particularly in light of what might

happen in litigation and things. You can use stipulations or whatever.

I think the reason why the lawyers, if you will, want to be present, at least the reason why I want to be present on those phone calls, is not so much out of a litigation concern. Because quite frankly, I don't have much of a litigation concern. None of my cases seem to go to litigation, although I'd love to get these contingent consent decrees up so I could get some into litigation.

But, you know, they tend not to go into litigation, and if they were to go into litigation, I'm using a different economist to litigate it anyway, and that's not because I don't have a great deal of respect for the ones I bring into the agencies. What it really is is just the opposite. What I want to be able to do is have a really free and open conversation with my economist about all the various theories that could be in the case, walk down lots of what will eventually end up to be blind alleys with him or her, and I don't want to be worried about what's going to come back to haunt me with that economist in litigation later.

So the economist that I bring into the agencies, you will never see, or almost never see as testifying experts in a litigation. And I think that

solves a lot of the problems. But I do want to be on the phone just to hear what's going on, because that helps inform me. My constant quest as defense counsel in this is trying to figure out what are the operative theories of anticompetitive harm that the agency is testing, and I'll take every opportunity I can to try to figure that out.

Now just one last quick thing. On what Jonathan said, I think something very interesting has happened at the agencies. I think the cases dichotomize. I think there are some cases where the economists are very interested, particularly front office economists are very interested, and you see basically a lot of economic content in the investigation. But I cannot tell you how many investigations I've had in the last five years where there has been essentially no real economic content in the investigation.

And what's really happened is the lawyers have internalized the basic economic paradigms that have been developed, and now they think they no longer need the economists to assist them. And, you know, you will find economists, quite frankly, who aren't necessarily interested in pushing themselves onto the legal staffs to get really involved, and they just sort of go along for the ride, and you never see them, at least from the

outside, making any contribution in the case.

And I think there is a lot of internalization that's going on, and I think in a lot of cases, the economists basically are not players.

MR. PATE: Other comments? Dan?

MR. RUBINFELD: Well, in answering your question I always look for a natural experiment that will help me to tease out the answer to the question, and the natural experiment is to compare the level of analysis here in the U.S. to, say, the level at the European Union.

As you know, the European Union really has, at least as I see it, has lagged behind the U.S. because they have not until relatively recently really fit the role of economic analysis into a central place in their decision making. And I think for me that's part of the explanation for some of the problems the EU had in the cases that were overturned at the CFI over the last year or two.

So I think generally among the players, including folks around here, the economists and lawyers really handle the sharing of decision making analysis quite well. The EU is really in a starting plane, and I think that's part of the difference. We're able to incorporate much more rapidly our knowledge about

industrial organization and about empirical methods here just because we have economists as well as lawyers making key decisions.

In the sharing of the decision making, at least during my experience, was not a problem at all. It worked very well.

MR. PATE: Jim Rill?

MR. RILL: Yes. Certainly I don't disagree with Jonathan's premise that a large part, most of the foundation theoretical work that's been done over the last couple of decades, has been generated out of economic discipline.

I think, though, the best and most effective economists that I've worked with, and it would certainly include everyone at this table, are the ones that recognize that it's important not merely to talk econo babble to the other economists who will speak that same language in the same obscure dialect, but recognize that at the end of the day, it is the lawyers who will be making the decision in the front office, and it is the lawyers down below the front office and throughout the chain that need to understand and work jointly to develop a comprehensive matrix of decision making process that brings the economic thinking into terms that's manageable, practicable to legal thinking, not only for

litigation processing, but also for processing all up the line.

That doesn't mean dumb down. That means put down into practical terms and realistic terms based on empirical evidence rather than perhaps dancing around non empirically-based fanciful simulation theories. And I'm not talking about anyone in this room, of course.

MR. PATE: Dennis?

MR. CARLTON: I guess I have two comments. The short answer to your question, should economists take over is obviously no, because economists believe in comparative advantage. And even though economists may be able to articulate theories of anticompetitive harm and analyze evidence, they're not very good at process necessarily.

We are not trained to go through a process that respects certain rights and certain expectations. And that's why I think the lawyers will always remain involved, and since it's ultimately the court that is the final threat, I think the lawyers will continue to play a large role.

What that suggests, though, is a great responsibility on the part of the agencies, because they are typically much more sophisticated because they have more economic expertise than a court. And, therefore, I

find that the sophistication of the arguments you can use before government agencies is much greater than you can expect to use in a courtroom because the level of understanding is so much greater.

And that means the great responsibility is when if you're thinking forward, even if you can win a case and you know you could win because the court's not going to understand the sophisticated theory, you have to, and obviously you do, exercise your discretion that you're not going to bring a case just because you can win it if the sophisticated theory that your economists sign off on exonerates the transaction.

So I think that's why the lawyers will always be involved in the process, because it ultimately ends or could end in court, but that does mean there's this heightened responsibility.

Now on the transparency issue, I am not sure I agree -- well, I don't agree with what Dale said in that when I'm an expert in a case, I like to know not just the good pints in the case but the bad points. I think that makes me an effective expert. In fact, I'm not sure how I can be an expert unless I'm aware of all aspects of the case.

So I actually think the best training for an expert who's going to be in a case is not to be shielded

from things. I always get nervous if some lawyer is saying, well, you can't see that, you can't see this. I say why not? I want to know everything about the case. I want to find out all the facts.

Now therefore, I'm much less concerned about saying something that will be used against me in litigation. Because presumably, as an expert, if I'm in litigation, I should have thought that through.

So I know there's this concern on both clients' part and agencies' part to let economists talk, and it certainly should be only reasonable discussion, not shooting the baloney. But I think there can be, you know, a lot of gains from trading can streamline processes by eliminating misunderstandings.

MR. PATE: Dale, a quick follow-up on Dennis's point?

MR. COLLINS: Yes. Just real quick. I don't disagree with anything Dennis has to say. My point was slightly different. And that is that I view economists -- you put them in sort of two camps, okay. There's the testifying economist and the strategic ones, the ones that are helping you think through lots of things.

My only point really is that on the testifying economist, absolutely. You want to make sure that they, you know, have all the facts, that they've thought

through things. But, you know, there's thinking through things and there's thinking through things. If I've got a strategic economist who has gone down a lot of blind alleys with me, and we've figured out what works and what doesn't work, you can sort of narrow the path, if you will, in a perfectly legitimate way for the testifying economist so that they just go down a much more efficient path, if you will.

And it's not that you've hidden anything from them, but you don't also go say, well, let me tell you about the 15 theories that we worked out that we decided we're not going to run in this case. Those theories shouldn't be part of the case. We're not running them. You know, there's no reason to confuse people with them.

So, I like the economists to have lots of knowledge about the case but, if you will, be very efficient in the path they go down.

MR. PATE: Okay. Let's move to the data release that the agencies made before this workshop got underway, and I'd like to turn to the panel and ask were there any surprising conclusions that you thought you were able to draw from the data? More generally, did the data release tell you anything about enforcement that you think would be useful to share on the panel? Bill, go ahead.

MR. BAER: I'll start. Briefly, I've talked about it a little bit before, I thought the things that were -- the fact that the challenges were associated with much higher HHIs and deltas than the Guidelines said, it really surprises no one who has followed this. And that really, I think, results from the discipline of the '92 Guidelines and the requirement that enforcers tell a story upon, that it becomes more nuanced and not just a numbers game.

I was a little surprised to find that with respect to the FTC data, that hot documents were important in such a small percentage of the case. I think that may reflect better counseling going in, because I think in the mid-'90s when I was there in fact, I think a pretty high percentage of the cases we brought at the FTC did have hot documents.

But I think Dennis or someone mentioned this earlier, the results which suggested that at certain HHI levels and increases in concentration, that if customers provide serious, credible complaints, that your chances of being challenged are about 100 percent, was really quite remarkable. And it would be interesting to have a better feel for what the standard of credible customer complaint was.

But the fact of the matter is, I think the

process is increasingly, once you get the numbers out of the way, if you have what documents you have, that if the customers are telling a credible story of harm, the agencies seem anecdotally now in connection with the FTC data release, very, very much inclined to weigh that and to bring the challenge. That was really the most interesting thing, I thought.

MR. PATE: Jon?

MR. BAKER: I read the numbers slightly differently than you, Bill.

MR. BAER: It's not the first time, Jon. It's just been a couple of years.

(Laugher.)

MR. BAKER: This time the Commission is going to be with me. I focused on the FTC data, and looking at those, and I was particularly interested in the other markets, not the industries where the repeated play was the groceries and the oil and where you wonder whether the standards are different in those industries.

And the message that I got was that the hot documents and the customer complaints mattered, but only in the cases that were close.

(Interruption to the proceedings.)

MR. BAKER: My problem was a lot of those cases where the hot documents matter and the customer

complaints matter were cases that would have been brought anyway based on the concentration. That's what I'm really trying to say.

And what was interesting was where things mattered in looking at those other markets, the four- to-three mergers were the ones that could have come out either way based on these numbers. And there, when you had hot documents and customer complaints, it made a giant difference. It was the ones that the concentration put it in an iffy area for the agency where the documents and customer complaints mattered.

MR. WILLIG: As usual, with numbers like these, there's the question of the exogeneity or endogeneity of the characterizations of the fact of the case.

MR. PATE: Isn't that what I said earlier?

(Laughter.)

MR. WILLIG: Was it?

(Laughter.)

MR. WILLIG: If there's a case there, all of a sudden there's going to be a lot of very credible customer complaints. But if there's reasons that the staff chooses not to bring the case; customer complaints, no valid ones that I've seen. So it's the cart before the horse problem with data analysis.

MR. PATE: Fair enough.

VOICE: That's why you should look at the BE memo.

MR. PATE: The admonition from the conference call operator to please talk into the mike. Dale, do you have a follow-up?

MR. COLLINS: Yeah. Actually just to Bobby's point, I think there are things you want to think about with the data. I mean, one of the things that certainly I see in negotiation of consent decrees is that sometimes the way the staff has defined the markets, I really don't care how they define the markets, right, once I've negotiated the relief. But sometimes you get sort of surprised at the way some of those markets may have been defined.

But leaving that, I don't think that's a problem that's sort of endemic through this. I think that the most interesting thing is -- and I think a number of counselors have been saying this for a while -- but there's a pretty good predictive test when you're talking to the clients right in the beginning to figure out what's likely going to happen with your transaction.

And that is, you don't ask them questions about market definition or anything like that. What you do is you ask them let's talk about your significant competitors, and you're presumably acquiring one of them.

If you've got five significant competitors and you're going down to four, the chances that that deal is going through is probably pretty high. I mean, you know, not always, but by and large, you can bet a lot that that deal is likely to go through.

If it's four to three, it's going to be a battleground of sorts. If it's three to two it's going to be even more of a battleground, but if you've got good efficiency arguments and you don't have any customer complaints and your documents are under control, you've got a fighting shot on that. You've certainly got more than a fighting shot if you're on four to three. And if it's three to two, you've got to have a really, really good story and you really can't count on it.

And with that, that pretty much captures the whole analysis. You know, you don't need to discuss a whole lot of things more with your clients. And this data bears that out.

MR. PATE: Jim Loftis?

MR. LOFTIS: And all of that is done, you know, virtually in the wink of an eye without a simulation analysis.

(Laughter.)

MR. LOFTIS: And before the second request. I've done very much the same thing Bill Baer was talking

about, which is to look at the documents that I used for the initial analysis that Dale has just described and looked at the documents that were relevant after the agency investigation, and by and large, they're the same.

MR. PATE: Other comments on the data?

MR. WILLIG: I look at the data and I'm happy about the Guidelines, and I'm happy about enforcement decision making. It shows by and large that concentration is taken seriously, and when we get up to the ranges that we've all experienced theoretically and experientially to be really dangerous ranges, there's a lot of enforcement action. And yet the numbers are not followed slavishly. There's lots of variation around that.

The safe harbor seems to be taken very seriously with I think the right measure of caution, so it's not exactly 1,000. There's kind of an extension of the relatively safe harbor above that. It's a very healthy picture alongside of the Guidelines, I think.

MR. PATE: Let me ask about customer complaints. We talked about that in the context of the data, and I'll make the not very shocking revelation that customer complaints do matter inside the agencies; that if we're seeing customer, not competitor complaints, where a substantial story is being told, particularly of

specific instances where competition between the merging parties has been of value in terms of price or quality, that it does make a difference.

MR. PATE: But the question I wanted to ask is, are there areas in which the economists, the lawyers, think the agencies are not taking customer complaints into account properly ways in which you've seen that factor being misapplied. Jim Rill?

MR. RILL: As one who opened the question, I don't think there's any serious disagreement. I don't think there can be any disagreement with the notion that serious, credible customer complaints are certainly revealing as to the possible likely anticompetitive or competitive dynamic of the transaction. I certainly don't disagree with that.

I'm concerned with the possibility at least of the caveats -- of the conditions, the qualifications -- what are serious and credible customer complaints. Are they complaints that are genuinely revealing of a potential anticompetitive consequence of the transaction based on the customer's independent look at the issue, or are they -- and this is not a comment on agency lawyering at all -- I'm sure none of us have ever done it -- but those people out there who might be opposing the merger often can generate paper, statements, declarations to

provide to the agency from customers who are concerned with the transaction, whose concern maybe they don't like change. They don't like one of the acquired companies.

Those concerns, however, can be phrased by someone, by counsel opposing the transaction, into a statement that sounds like a competitive-based customer complaint. It's incumbent on the agencies, and I'm sure this is preaching to the converted, but it's incumbent on the agencies, I would think incumbent on good lawyering in opposition as well, to sift through the surface of those complaints, to focus, in the words of the report, on "serious and credible" concerns with anticompetitive consequences of the transaction.

MR. PATE: Dan, you had a comment?

MR. RUBINFELD: I actually want to just take what Bobby said about what he described as the endogeneity of the customer complaints and sort of expand on that.

Bobby was describing the fact that the study itself may involve reinterpretation of what's an important complaint or not, and beyond that -- it goes to the strategy the customers might be using when the deal is either announced or about to be announced. And I think it just means we have to be careful about interpreting complaints.

The examples I have in mind are Customer A is unhappy with the deal they have with the acquiring parties, so they either complain directly or make it clear they're going to complain, and lo and behold, they have a five-year contract to get a lower price on their product. And it fact, it may be that their complaint is not valid at all.

Now you can take that several ways. It could be that you hear a complaint that's not valid, it could be there's a real complaint out there, but you're not hearing about it because the customer has been, let's say, compensated ahead of the time.

MR. RUBINFELD: Exactly. And I have to confess that I've seen that happen in a couple of deals I've been involved in.

So that means that for the agencies, the issue of how to process these complaints is an important one, and it has to be done with great care.

MR. CARLTON: I think that's likely to become an increasingly serious problem now that it's known how important customer complaints are.

MR. RUBINFELD: Right.

MR. CARLTON: In other words, at the beginning, I think it's absolutely right you want to be very cognizant of customer complaints and then once it's

known, that that can have an enormous impact, customers realize how much power they have.

So it's really going to be a touchy issue going forward, I think, to sort out the real ones from the ones that are just strategically designed to get a better deal.

MR. PATE: Dale?

MR. COLLINS: I think that, obviously, customer complaints are important. But even from a defense counsel's perspective, I think we should recognize that they are properly important to the decision making at the agencies.

But having said that, I'm just really going to repeat some things that have already been said. I think it imposes an enormous obligation and responsibility on the agencies to properly sift through those customer complaints.

And let me suggest that there are two problems that you need to watch out for, those of you who are in the agency.

MR. BAER: Dale, can I interrupt? Do you think there is actually a problem historically? I mean, looking back the last four or five years where the agencies have not properly valued complaints? I mean, is there a systematic problem?

MR. COLLINS: No, I don't think it's a systematic problem. I think it is an occasional problem, but given the importance that the complaints have in the decision making process, I think the obligation on the agencies is extremely high to make sure that the complaints are properly vetted.

It's particularly true since the biggest frustration I have as a defense counsel is I can't get to the people who are complaining and cross-examine them. I mean, in a lot of these cases, I am convinced to a moral certainty, probably wrongly, but still convinced to a moral certainty: give me five minutes with the witness and I can turn 'em.

MR. RUBINFELD: Can I interrupt just to liven the conversation? How about sending affidavits to your client? Have you ever had that happen?

MR. COLLINS: Oh, yeah. Yeah. Oftentimes what will happen is that a complaining party, a customer, has gone in, gotten an affidavit with the agency, and we don't know about it, number one. And moreover -- and I've got specific examples of this, we sort of found out after the investigations were over, that they're coming to us and saying we really love the deal, and they've already got a complaint in at the agency saying they hate the deal, okay. I would love to know about those cases,

just in order to sort of explore those issues.

(Laughter.)

MR. COLLINS: But let me go back to the obligations on the agencies. And there's two kinds of problems, one we talked about and one we haven't talked about. The one we talked about is strategic behavior on the part of some customers, and it's important for the agency to find out about that strategic behavior.

The other one, I think, is far more pernicious but thankfully it is extremely rare, but it is not nonexistent. And that is, we will occasionally find, and I find this out by representing third parties who have been interviewed, particularly third parties that have been interviewed when I'm not on the phone. And then an affidavit comes across from the agency, and it says please sign this affidavit. And you look at the affidavit and the witness looks at the affidavit and said this isn't what I said. First of all, it's far more elegant than anything I possibly said in the conversation, and it lays out a theory of anticompetitive harm that I didn't articulate in the conversation.

And we've had one case, my sort of favorite on this, but we've had one case where we took the affidavit in, spent a lot of time with the witness -- we were a third party, and we had no real interest in the deal, and

rewrote the affidavit that was sent to us or sent to the client to be signed, in a form that the witness was far more comfortable with. We sent that down signed to the agency, and like three days later got hit with a CID to go down and testify for a day on why we made the changes to the affidavit.

I'm not saying that that shouldn't happen, but I think the section chiefs should always be watchful that the attorneys in their section when they're doing affidavit work and they're talking to witnesses. It takes a lot of training. If you're really, you know, doing good government work to do that right. And one way not to do it is to sit there and basically ask a series of leading questions to the witness who just wants to get off the phone, and then write up an affidavit that basically is just the affirmative versions of your questions.

And like I said, it doesn't happen much, but it happens enough so you've got to keep a watchful eye for it.

MR. PATE: Okay. Let's turn to innovation markets. We've had a couple of comments, I think Bobby making one that this might be one of the most important topics to address going forward. I'd like to ask the panelists, do you think that the agencies ought to bring

enforcement actions on the basis of innovation markets? Would you be in favor of that/against it?

Secondly, in terms of the Guidelines, do you think a future product or a potential competition analysis suffices to deal with innovation market situations, or do we need, as I think Bobby suggests, some more explicit attention to how R&D and innovation are handled in merger analysis? Jim?

MR. LOFTIS: I think the fundamental problem in many situations is we don't understand what causes innovation, and therefore, we don't understand very well how it's going to be affected by a transaction. And if any resources can be put towards studying, not just from a legal or an economic point of view, but studying what the foundations of innovation are, that would be extremely helpful and maybe should be the threshold step towards understanding how we go about dealing with it.

Because what happens if you put together two firms that have fabulous brainpower in microbiology, I mean, how do you know that that combination is going to have anything at all to do with innovation? What do you do with the outlier, the fellow in the garage, who comes up with the next brilliant idea? How do you factor that into your analysis?

I guess my point is we just don't know enough

at the threshold to go very far with this.

MR. BAER: When I came to the government in '95, this was the hot topic. The first innovation market case had been brought. The question whether you needed to have this concept at all or you could rely on potential competition.

I think the way it's played out, there isn't much debate. The point Jim makes was a theoretical concern a lot of people voiced, we're basically going to be trying to handicap who has a better idea and whether combining two bright guys is going to somehow basically corner the market on good thoughts? But that hasn't how it's been used.

I mean, it's basically, in the hypothetical, Jim, you posed, where you had two people thinking about good things, the fact that they get together doesn't trouble me. The troubling fact would be that they patented the whole field and between the two of them have the patents which, if kept separate, would allow the IP, would allow them to compete, that they're going to be put in one pool and nobody else can get in, so you may lose different lines of innovation -- that sort of stuff.

This was Ciba Geigy/Sandos merger analysis. We had this issue with gene therapy where the two entities controlled most of the IP necessary to pursue gene

therapy.

So, for me, the concerns haven't really borne out because it's largely been applied, innovation theory, in the context of pharmaceuticals where you have a pretty good idea what the pipeline is like, you can make some judgments about how to handicap likelihood that there will be other people in it, at least more informed than in other non or unregulated markets, and whether at the end of the day you could have used potential competition theory to get to the same result doesn't bother me one way or the other.

I mean, at the end of the day, the concept analytically has some value, I think. And as long as it isn't applied in a way that is overbroad, I don't see much to debate. But I may be in a minority.

MR. PATE: Dale?

MR. COLLINS: I agree with Bill. And I think that a lot of the debate on, if you will, innovation markets, starts off with the wrong foot by the use of the term "markets" because most of the discussion really isn't about markets. It's really about whether or not you can locate an anticompetitive effect along an R&D dimension.

Is the R&D going to be slowed down as a result of this transaction? Or if you're using it on the

defense side, will it be increased? Will the pace of innovation be increased by the transaction? That's a discussion you can have totally apart, if you will, from questions of the metes and bounds of the marketplace.

I think the first thing that I would suggest on this whole question of innovation is that the agency sort of adopt an internal rule that says we're not going to talk about innovation markets if there's any other way to talk about the problem. And that'll solve like 90 percent of the difficulties right there.

(Laughter.)

MR. COLLINS: And that doesn't say that you don't talk about innovation, because innovation could be a perfectly legitimate dimension on which to assess the competitiveness of a transaction. You just don't use the term "market", you know, to talk about it. I think this whole thing, and Dennis has already mentioned this -- sort of started off in some ways on the wrong foot with the ZF case. If I remember the complaint in ZF, what they did was they defined both innovation market and then they applied what amounted to a Herfindahl. They incorporated a Herfindahl allegation in order to presume an anticompetitive effect in this innovation market based on, if you will, the market shares.

And as I said, I think that that really got

things off on the wrong foot. And if you read the complaint, it was completely unnecessary to do. There were other allegations in the complaint that could have gotten you to the same result without any trouble at all.

MR. PATE: Bobby?

MR. WILLIG: What they presumed in part was that a base of market share in the tangible product is an important impetus to doing R&D. And so the theory was if you put the two major producers of the tangible product together in the merger, then you're putting together the two lead players in R&D space, leaving R&D with less competition and therefore less force for moving the frontier.

The trouble with that is that in economics and common sense, and I think business experience, it's true there may be a relationship to market position and impetus to R&D, but that means that if you put together two players and they become bigger, they've now got a bigger base of motivation to invest in improvements.

And it's the old Schumpeterian effect which has been a very real effect studied by economists that the bigger players with more clout in the marketplace actually have more incentive to do R&D as long as they've got some spur, and that spur can come from competing purveyors of R&D, or a competing product manufacturers.

It's a complex melange of forces, and we don't have Guidelines to help us sort them out.

MR. PATE: Dennis?

MR. CARLTON: I would say that the innovation market concept is a bad idea because it does suggest you're going to take market shares and you're going to do HHIs. To whatever extent you think the usual Guidelines using HHI's are crude, these are completely without any theoretical foundation.

I agree with Bill that in pharmaceuticals, because there's a pipeline, you can predict what's coming on line, and therefore you have better predictions about future products. But I think that is actually an exceptional case. In most industries, there's not necessarily a time line, and it's actually very difficult -- this is what I was alluding to earlier -- to predict where innovations will come from.

Take the transmission case, the ZF case. There were people who made transmissions for other products, other than large garbage trucks, which was one of the issues, or buses. And they were related. So if small trucks, medium size trucks, and innovations in those technologies were thought to be able to spill over, I don't think the premise that innovation is necessarily going to come from people in that market, that product

market, necessarily holds true.

But just to reassert something or confirm something Bobby said, I think he's exactly right. We're not sure. The evidence in industrial organization is quite ambivalent as to exactly the effect of concentration on R&D if you do cross-sections.

Now maybe in studying a particular industry, that is, if there is a particular industry in which there's a merger and you can say look, it got concentrated. They did less R&D. It got concentrated. You keep doing less R&D. Well, maybe you can make specific observations there. But I think it's very dangerous to have a generic rubric of innovation markets. R&D is a concern.

We'd like to be able to say more -- I would like to be able to say more about it. I agree with you, it's an important area for study. We don't know a lot now about it, it seems to me, that we can give general Guidelines, other than studying a specific industry that's under analysis, I'm not sure what else to suggest. And I'm worried if you did something that would create a new rubric, and people would take advantage of it, and I think it would just lead to confusion.

MR. PATE: Dan, I think you were first and then --

MR. RUBINFELD: I feel like I should say I still like innovation markets, although I will agree that the word "market" itself isn't very important. But I think the really important point is really the one Dennis just made.

It is true, and I think I agree with the characterization that Bobby made, that if you look at the empirical evidence in a typical cross-section, you're not going to see a clear relationship between concentration and innovation. But if you start looking deep down into the numbers, I think in specific industries, in particular types of situations, the data will tell you and the economics will tell you a fairly coherent story that links reduction in competition to less innovation.

One example I happened to think of was some of the work the Division did involving some of the defense mergers where there's a very, very specific theory laid out of the way in which innovation occurs, and I think a very compelling story about why three to two, for example, will significantly affect innovation and harm consumers.

So let's not take away from this message about the lack of consistency of the cross-section the idea that we can't develop for specific industries and specific kinds of innovation a compelling story based on

the evidence.

MR. LOFTIS: Let me just take issue with that, may I? Since you hit one of my favorite topics.

MR. RUBINFELD: You represented one of the parties probably.

MR. LOFTIS: No, no, no. I think you need to make a distinction as to the viability of the theory that you're referring to between innovation in the sense of advancement and innovation in the sense of overcoming technologies. That really makes a huge difference in what you're talking about.

MR. PATE: Jon?

MR. BAKER: Regardless of what the facts are in the ZF case, I don't actually think we're disagreeing over the principle there. That is, if there's certain identifiable assets that the firms have that are important to new process or product development, maybe it's in the pipeline already. Maybe it's patents. Conceivably, it's current generation products or expertise and distribution or obtaining regulatory clearance, but you'll want to debate that on the facts.

But if there are only a handful of firms with the existing assets that you need to go forward and you're having a merger among them, the agencies are right to be concerned. The dispute about ZF that I'm hearing

is about whether the evidence that was pointed to by the agency really falls in that category or not.

On the broader question that Dan and Bobby have been on about -- and Dennis -- about the relationship between R&D and concentration, the last time I looked at the literature, and maybe it's been sufficiently long ago that I'm not up to date, but when I looked through most recently, what I thought I took from the literature, is that, yes, if you look at these cross-sectional studies it appears as though it's ambiguous as to whether increased concentration is associated with more or less R&D.

But if you control for appropriability, that is, that there are some industries where it appears that you need to have large shares of the existing products in order to be confident that you're to be able to appropriate the benefits of your innovation, the intellectual property protections aren’t good enough there to guarantee appropriability, and once you control for that for industry type, then the relationship comes back. And so that it looks as though that increased concentration is associated with less R&D, once you're confident that the firms have some other way of appropriating the benefits of their new ideas than merely just being large.

So I think there's a basis for antitrust enforcement from that literature, but I agree that it takes some teasing out to get to my interpretation of it, and that, you know, people could disagree about that.

MR. PATE: Other comments on innovation? If not, Jim Loftis mentioned monopsony as a question going forward the agency should pay more attention to.

MR. COLLINS: Could I just say something? I'm sorry for interrupting.

MR. PATE: Sure.

MR. COLLINS: There's something in the literature recently on patents that I think does merit antitrust concern, and that's the following. There's been a finding that the number of patents has skyrocketed, and that the way people are using patents are as like a medium of exchange, a currency, in which I'll give you my patent if you give me your patent, and does not explore the reason. It's just we agree to share.

And, therefore, someone who doesn't have this currency of patents sometimes may have difficulty participating in these cross-licenses. I think that's an interesting -- I just want to raise that. I think that's an interesting phenomenon, and I think that's something people should keep their eye on as to the antitrust

consequences of those practices.

MR. PATE: Well, it's a good point. I can put monopsony aside for a moment. The agencies obviously have been doing a lot of work on antitrust and intellectual property, primarily focusing on patents. Are there any issues that others on the panel would like to comment on with respect to merger analysis and IP? Any particular aspects of that that you think we ought to be paying attention to?

(No response.)

MR. PATE: No.

(Laughter.)

MR. PATE: It's a topic that's been well enough dealt with. All right. Let me take up monopsony questions then. A frequently heard contention in this field is that the agencies ought to be much more concerned about monopsony at lower levels of concentration than those about which we should be concerned in the context of monopoly power.

Marius was on a panel earlier in this series where he suggested he didn't think that current learning really supported that assertion, but it is one that's pretty powerful, and I'd like to know if there are any reactions from the panelists on that point.

MR. WILLIG: I hadn't heard that strange idea

myself.

(Laughter.)

MR. BAER: Because if anything, the agency guidance these days in health care, and other things that, there is a threshold or a safe harbor in terms of a buying cooperative. This is not the merger analysis, but cooperative activity that you wouldn't be allowed to do if it were a seller-coordinated effort. It would be per se unlawful on the seller's side. You actually have safe harbors up to 25 or 30 percent on the buyer's side.

My own sense on whether we need to do more or whether we're going about it right on monopsony analysis in merger cases, is that you go back to the Guidelines requirement. You tell a story and understanding over time how increased power on the part of the buyer is going to distort the market, you know, and looking to some sort of effect that is anti-consumer is the right way to look at it.

I think just as in predatory pricing cases, you want to be a little bit careful. You don't want to chill lower prices. And so having that kind of slightly more cautionary mode in mind is probably the right way to go at look at monopsony, to my way of thinking.

MR. PATE: Bobby, let me make sure. Were you incredulous at Marius's response or the theory to which

he was responding?

MR. WILLIG: No, at the idea that the agencies had a different sense of concentration for those two concerns. But if I can follow up on Bill.

MR. PATE: Sure.

MR. WILLIG: Just to lay it out a little bit more, we frequently encounter the idea that among merger efficiencies is the ability to buy more effectively, i.e., cheaper. And of course that sounds a lot like monopsony at the same time. How could a theory of anticompetitive effect be indistinguishable from a theory of efficiencies is really a challenge. And I think there's a very simple answer in economics. I wonder if Marius agrees from his earlier work.

But for me, it has to do with output, as usual. But it's not downstream output, it's upstream output. It's output in the market where the monopsony power is said to be of concern.

So if the better clout from the merger on the efficiency side enables more effective procurement, that should also increase the output of the upstream supply. But if it's an abuse of market power to get the lower price upstream, that will be associated with fewer purchases or less quality purchases of the upstream supply.

So we're back to output as the distinguishing feature, but it's output upstream, not downstream.

MR. PATE: I think I have the advantage of knowing Marius does agree. But let me ask about the time frame. What would you suggest the agencies do with a situation where there is a real efficiency in terms of buying power that decreases price in the short term, if a credible case were made that output would decrease in the long term? That's another aspect of this argument that gets presented frequently.

MR. WILLIG: Oh, the low price denies ability upstream to invest?

MR. PATE: Right. That production choices are altered because there's not a sufficient return.

MR. WILLIG: No, I worry about that, and I would call that a possible exercise of monopsony power if the investment base is removed from upstream supply through procurement.

MR. CARLTON: I think there's a confusion between monopsony and bargaining power. In terms of the literature on the cases of monopsony and the concentration levels of monopsony versus monopoly, as a general rule, you can only have monopsony if you have an upward sloping supply curve.

Now it's not clear that you have upward sloping

supply curves for most industries in the long run. In the long run, a good first approximation for many industries is the supply curve is pretty flat, so there's nothing to monopsonize. It's only in industries where there's specific capital -- rents or human capital -- that we think that there can usually be monopsony power, and that's the reason I think that explains the relative paucity of studies documenting monopsony compared to market power.

Now even in those cases in which there is an upward sloping supply curve, sometimes it is upward sloping and then it's flat. Take the case of sports, the supply of sports talent. There are some people who are terrific, and then there are some people whose alternative is, you know, doing nothing else but, you know --

VOICE: Law school.

MR. CARLTON: Yeah. Law school. Okay.

(Laughter.)

MR. CARLTON: And what you've got to be careful in those cases. If there's differential pricing, suppose you pay different sports figures different prices, there need not be a restriction of output. I agree with Bobby. It's the restriction of output that matters, okay, so that's often the case of monopsony, that people call

monopsony. It's really differentiated pricing and doesn't lead to a supply restriction.

And in other cases, maybe in the short run there's an upward sloping supply curve, but not in the long run. So there's no restriction of output.

Bargaining theory is usually what's going on when someone's complaining that someone's going to obtain more power. That just means they're going to get a better bargain. And again, the issue is, in the long run, is that going to alter investment? And if it does, then you should be concerned with the restriction of output, but if it isn't, then it's just a reallocation of the rents, from the transaction.

So I have always thought monopsony was less of a problem than market power because of the shape of the supply curves. And there's one error that's often made, and that is that monopsony lowers price, that's true, but it restricts output. And the lower price is not a benefit. That shouldn't be counted as a benefit. That's actually a cost to society because it creates a dead weight loss.

So it really has to do with restriction of output. And anytime there's a restriction in the input market, that generally is going to lead to a restriction in some output market because the input was being used to

produce some output.

MR. PATE: Dan?

MR. RUBINFELD: Just to follow up. I actually have more of a question than a statement. It's related but not quite the same point. We were talking about a horizontal merger involving an output product, but the merger happens to be in an industry where there is one or two very significant buyers, very significant buyer market power. I think one's natural reaction, but I'm curious what you think.

We used to think of this as really a bargaining issue and not a pure monopsony issue, but can you think of situations in which you would think that the presence of significant buyer power would be enough to counter any possible adverse effects, price effects of the merger?

MR. WILLIG: We're not doing monopsony now?

MR. RUBINFELD: I'm just shifting over to a slightly different question.

MR. WILLIG: Okay. But there's still things to fight about on monopsony.

MR. RUBINFELD: Okay. We can move. Hew can cut me off if he wants to.

MR. PATE: No. Anybody want to take up Dan's question?

MR. WILLIG: For me, what buyer power is all

about in a merger analysis is it's an important part of the structure of the output market to understand, and part of our obligation to do good analysis under the Guidelines generally is to work through the consequences for the way the firms are competing, and the remaining competitors in the market in view of the nature of demand, which include the big buyers.

So, for example, it may be tougher to imagine a coordinated effects theory if there's big buyers who are in control of their own procurement.

MR. CARLTON: I think the big buyer can protect himself, by vertical integration, for example, or by his bargaining power to sign a contract for supply. The question is, how do the other buyers protect themselves? And that then raises the question, is it one price for the product or differential prices? And that seems to me very important. I think that's taken into account when the agencies look at things.

But as a general matter, I think heterogeneous pricing in products and also whether it's services or a durable good, are important considerations and have very large impacts on competition.

MR. PATE: Dale?

MR. COLLINS: I think that in answer to Dan's question, I've always thought that buyer power can play a

role in the defense of a transaction, but what's critical and I think what so many defense lawyers fail to do is explain the mechanism by which the buyer power is being exercised.

They just say there are big buyers out there. You know, that by itself, quite frankly, should get you nowhere on the defense side. You need an explicit -- you need to be explicit about the mechanism by which the buyer, in the context of the industry and that particular buyer's attributes, is actually going to be able to effect a price change, if you will, in order to protect itself.

And I think Dennis is absolutely right. When you get into all the characteristics, you know, the nature of the products, whether or not there's price discrimination, there's going be a huge problem in these buyer power defenses.

MR. PATE: Let me try to get some comments on coordinated effects. A couple of years ago Charles James suggested that perhaps unilateral effects had driven out coordinated effects, and that outside of stylized maverick stories, coordinated effects wasn't getting enough attention.

Jonathan, I was interested by your comment leading off that coordinated effects has been so

reinvigorated that you think it's driving out unilateral effects. So let me just use that to solicit comments on where we are in terms of use of coordinated effects theories in merger analysis and where should the agencies be, and where should they say they are for the benefit of outside parties. Do you want the first shot?

MR. BAKER: Sure. I think what the agencies have been doing the last few years in coordinated effects has been very healthy and very interesting. And what's been clarified are a couple things. One is that there are two different questions that you have to ask. One is, how do the firms in the industry solve their cartel problems, reaching consensus, deterring deviation, by detecting and policing cheating? And then how does the merger matter? And that the factors in the merger Guidelines aren't just some sort of checklist. They're part of the way that integrated analysis that have to be directed towards whether and how the firms solve their cartel problems.

And there's a lot of empirical evidence that could bear on that. And there are interesting papers coming out of both agencies, or people who worked in them, with lots of little empirical tests that might be relevant to understanding specific coordinated interaction stories. They all have to be tied to the

story.

If you think the way coordination works is on price, then issues about transparency might be important. If you think it's a customer allocation, then it's a transparency of customers, not the transparency of prices that matters. But with that kind of a caveat, the agencies have been very thoughtful and moving the ball forward on doing empirics in the coordinated interaction area.

And then in analyzing whether and how the merger matters, I think that's what mavericks are all about; that there's always a constraint on coordination. Coordination -- you would generally expect if it exists to be imperfect and incomplete. In that kind of a setting, the issue is, well, why is it imperfect and incomplete? What firm doesn't want to go along or can't be, of course, can't be paid off with side payments or punished more vigorously to force it to go along, and then how does that constraint get changed by merger?

And I would incorporate a presumption that if the merger involved a maverick, it would be harmful. And if it didn't involve a maverick, then you need to analyze how the merger affects the constraint, the mavericks. And so that's how I think the agencies are evolving towards understanding these coordinated effects cases,

and it's healthy.

MR. PATE: Jim Rill?

MR. RILL: Yes. I was with you up until the presumption on the maverick. But, no, I think the agency enforcement procedure and the Guidelines really are quite good on coordinated effects.

When we developed them in the 1992 Guidelines, there was some sort of criticism that there was a large number of criteria and a large number of considerations, a large number of elements that were thrown into the pot to identify situations where coordinated effect might be the basis for a challenge to the merger.

I know the ABA was somewhat upset: What are you doing? You've given us a stew. You haven't told us what the principal ingredients are. I think we did the right thing, partly for the reason that Jonathan suggested, that cases are so fact-specific, and in many instances, so directionally pointed as to a particular focus of analysis to say, well, the real issue here is going to be heterogeneity. Well, in many instances, it's not. The real issue may be conditions of the downstream market.

So it has to be weighed on a case basis. And I think the agencies have done quite a good job on that. And I would not recommend, as some questions have

suggested, I would not recommend something to assign priorities to the elements of the competitive effects section of the Guidelines.

Presumption of illegality based on maverick, I have trouble sometimes identifying the difference between a maverick and a thoroughbred. And not being that good of an equestrian, I'd have to say that to create such a presumption, I think, would do considerably more harm than good across the board, because the maverick may not be so much of a maverick.

There may be a lot of considerations that makes him or her not a maverick, but based on other factors that make a somewhat difference from the basis of product and the basis of cost, from the basis of position, from the basis of influence in the market, that I think risks severe damage by creating that -- well, how about moderate damage, from establishing that kind of a presumption.

MR. PATE: Dennis?

MR. CARLTON: One concern I've always had with the quote, "maverick" theory is anytime you introduce new terminology, it sounds like it's a new theory. And what I've always preferred is to think of the maverick theory not as, you know, this new word "maverick," but rather the following. That the economic circumstances of a

particular company are such that they have the incentive to be particularly competitive.

And I want to distinguish that from they have some CEO who's off on a power trip and he's going to affect price for his ego or some other idiosyncratic reason. I don't think you want the identity of the person running a company to be an issue in a merger case. I think you want it to be the economic characteristics of the company. Otherwise, you're going to run into the problem that companies are going to have an incentive not to be a maverick because they know that will hurt them under the Guidelines. To have an innovative CEO who is doing innovative things, if that's going to hurt them, they won't have that type of CEO.

So I've always disliked the word "maverick" because it suggests someone's off, he's kind of like a wild man. And I don't like that. A wild horse. I don't like that. I don't think it should be wild at all. I think it's quite disciplined, quite predictable based on the economic situation that the firm faces. Otherwise, I think you're going to get into all sorts of puzzling policy conundrums that, should it be an antitrust offense if, you know, they fire Mr. X and hire Mr. Y? I mean, I just don't think you want to go in that direction.

MR. PATE: Jim?

MR. LOFTIS: I would agree certainly with the proposition that the agencies have gotten it about right in what they're doing in practice and that the stew or the checklist or whatever we wish to call it of the coordinated effects section of the Guidelines has not proved to be the gigantic problem that folks thought it to be.

But it is interesting that to see how the factors that are identified in the Guidelines under the coordinated effects section, to see how they are playing out in a slightly different arena. I would recommend that you take a look at the recent case law in private treble damage actions, largely on summary judgment, and just subtract out of that Sherman Act equation the consideration of agreement, and look at what they say about exchanging competitor price lists, trade associations. Every factor that is in the coordinated effects section of the Guidelines has been dealt with more than once by the courts to evaluate its significance in a specific industry.

And it's not entirely unlike what the agencies are doing in the merger setting.

MR. WILLIG: I thought where you were going, Jim, was that -- and this is my experience -- that the agencies are quite expert and responsible in sewing

together a complete story of coordinated effects, which takes into account both the plus factors and the minus factors and tries to sew them together to see if there is a coherent story of how the merger will make coordination more likely or worse for consumers.

But then in contrast, the courts are far less expert, and they look at the checklist of factors, and they treat it as a checklist instead of as a guideline for how to tell a story or see if there is a valid story.

MR. LOFTIS: Well, let's flip that around. I think you could also make the observation that if there is a weakness in the agency merger analysis of coordinated effects, it is a reluctance to conclude that there will not be coordinated effects from a lack of transparency, for example.

Take any significant factor that's necessary for that cartel to be effective. You have red flags that say maybe it's going to be effective. But if you subtract, if you can prove that there's no transparency, and, therefore, it's not going to be effective, I think there's a reluctance in the agencies to walk away for that single reason from a coordinated effects theory, which you don't see in the courts.

MR. PATE: Okay. Well, there are any number of other questions we could go into. The time has about

expired. What I think I'd like to do is go through and give each of the panelists an opportunity for a parting shot, one brief comment they'd like to leave us with as part of these proceedings and I guess to follow on our alphabetical theme, maybe I'll start in the middle and try to work out and give Jim Loftis --

(Laughter.)

MR. PATE: And, see, my name begins with "P" so it's always been my desire to run it this way. Jim Loftis, why don't you start?

MR. LOFTIS: All right. I just would observe that Guidelines are so very hard to write that will work. And what we have has gone through such a healthy process. I would not suggest additional Guidelines or revising the Guidelines, but I would suggest that resources be devoted to understand better what the circumstances of innovation are, both in the sense of improvement and in the sense of superseding technologies.

MR. PATE: Dale Collins?

MR. COLLINS: Yeah, I agree with Jim. I don't think the Guidelines should be rewritten. However, I do think that through speeches and discussions of enforcement decisions and the like, what should happen is that, in large part, the Guidelines should collapse, if

you will, into Section II.

And as a particular example of that, I think that the current structure of the Guidelines which I think Baxter may have started, of isolating efficiencies as a defense and suggesting that they are an affirmative defense as opposed to a negative defense that should be properly considered in Section II and not considered at all as an affirmative defense, the Guidelines, you know, the talk should be move it into Section II. Don't consider it separately.

MR. PATE: Okay. Jim Rill?

MR. RILL: Very little to add to what's been said by Jim and Dale. I think the Guidelines should not be revised at this time. I think the Guidelines are serving a very valid purpose in a progressive way. I would only advocate more transparency in the direction the agencies are taking now. I think the current release of the DOJ and FTC and the current FTC study is absolutely superb, and I think greater efforts to identify the rationale for cases not brought and basis for consent judgments would be very, very salutary.

MR. PATE: Dennis?

MR. CARLTON: Well, I echo everyone's sentiments that I think the Guidelines are pretty good as they stand. They're broad enough to incorporate a

variety of new approaches without having to rewrite the Guidelines. I agree with Jim that more research on R&D and dynamic efficiency is important.

In terms of the way the Guidelines are actually implemented, and as you develop techniques or improve techniques such as merger simulation or whatever, I think it's very important to do retrospective studies to see what has worked and what has not worked. And in doing that, it's very important not just to compare the mergers that you're blocking but also to see what happens to the ones you've let go, to see whether your techniques are able to distinguish between mergers that lead to price increases and those that don't.

So I think retrospective studies are extremely valuable for allowing us to assess where current practice should go.

MR. PATE: Dan?

MR. RUBINFELD: We've done a lot, the agencies and some of the folks out there, in developing empirical techniques and applying them to help us better understand how to distinguish mergers that are pro-competitive from those that are not. And we need to keep doing more of that, particularly actually in the area of coordinated effects, which we're doing now, and that involves both developing new techniques whenever possible, making data

public so that people can evaluate it, as well as doing retrospective work.

And we should try to avoid trying to get too simple rules of thumb that we think are going to apply across the board to many industries, because it's just not going to be the case.

MR. PATE: Jonathan?

MR. BAKER: I think Jim Rill's 1992 Guidelines have been remarkably successful, and that they still are what people on the inside and the outside rely on routinely in understanding how to think about mergers. And there's no real big reason to do much with them in changing them.

If there's going to be a next round of revisions, I think it's when we understand innovation better than perhaps we do now and how to think about mergers and innovation, but I'm not sure whether we've gotten to that point yet.

So on the whole, I agree with everything that everyone has said so far.

MR. PATE: Bobby Willig?

MR. WILLIG: Thank you. I think the Guidelines are actually terrific.

(Laughter.)

MR. WILLIG: I would love to see the agency

leadership send the message down the line on the lawyer side to try to allow yet more transparency and mutual interactivity among the economists, even in situations where there may be some prospect of litigation. I don't know if that's appropriate. But if it is, that message really needs to be sent down the line.

On simulation, I think it would be great to have an even more open process among the agencies' economists and outside economists who I think, in our case, would be delighted to see outsiders involved, not in a case context, but pushing the technological envelope and trying to share thoughts and coming to a better standardized set of techniques that everybody understands and gives some degree of approval to, not in a Guidelines setting, but in the sense of mutual R&D.

And when it comes to technology issues and mergers, I actually believe that even though we don't know all that we would like to know as academics, we know enough that if we put our heads together to try to write some sort of a draft R&D merger enforcement Guidelines, which will be an appendage to the convention Guidelines, not a replacement of them, we might actually make some progress. We might know enough now to be able to get some progress in that respect. It's worth thinking about and trying.

MR. PATE: Bill, the last word.

MR. BAER: It's unusual. I'll be brief. And that is, it's actually very rare to get the last word over Bobby Willig.

MR. WILLIG: I'm privileged.

MR. BAER: Not yet, apparently. The agencies under the current administration have done a great job on transparency in the broad sense. The points we made earlier about working to improve disclosure in pending cases, I think, remains an important one.

The points I made earlier which -- on process -- which didn't get discussed but don't necessarily need it, about making sure we're paying attention to the process, making the merger review process as efficient as possible, I think remain an area where there's opportunity for the agencies to improve.

MR. PATE: Okay. Well, it's really been a privilege, by virtue of my position, to be able to share the podium with such a distinguished panel of antitrust thinkers. I want to thank you for the time you spent today. I want to thank all of you in the audience for being here and those on the conference line as well.

(Laughter.)

MR. PATE: With that, again, thank you, even more particularly to the staffs of both the Trade

Commission and the Division who have done so much work to put this conference together.

With that, we are adjourned.

(Applause.)

(Whereupon, at 4:37 p.m., the conference adjourned.)

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CASE TITLE: MERGER WORKSHOP

HEARING DATE: FEBRUARY 19, 2004

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above cause before the FEDERAL TRADE COMMISSION to the best of my knowledge and belief.

DATED:

RITA HEMPHILL, C. V. R.

C E R T I F I C A T I O N O F P R O O F R E A D E R

I HEREBY CERTIFY that I proofread the transcript for accuracy in spelling, hyphenation, punctuation and format.

SARA J. VANCE