Panel 4: How and in What Context Do Cost Savings of Various Kinds Affect Business Decision Making? What Have Been the FTC and DOJ’s Experience with Efficiency Claims?

(Slides & Presentations)

Importance of Fixed Cost Savings in Antitrust Efficiency Analyses

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Overview

- Merger Guidelines acknowledge the importance of fixed costs savings
- Fixed cost savings can provide direct price-related consumer benefits
- Fixed cost savings can contribute to important non-price consumer benefits
- Importance of fixed cost savings should be assessed on a case-by-case basis

Merger Guidelines

- Identify efficiency-related consumer benefits
  - Lower prices
  - Increased output
  - Improved product quality
  - Enhanced customer service
  - Introduction of new products
- Fixed cost savings contribute to all these consumer benefits

Price-Related Consumer Benefits

- Fixed costs can directly impact pricing decisions
  - Studies conclude that many corporations make pricing decisions based on total cost
    - Govindarajan and Anthony (1983)
    - Shim and Sudit (1995)

Price-Related Consumer Benefits

- Govindarajan and Anthony
  - 1983 Survey of Fortune 1000 industrial companies
    - 501 respondents
    - 41 percent based prices on total cost
    - Additional 41 percent based prices on total production costs or total production costs plus other variable costs
    - Only 17 percent used variable cost pricing

Price-Related Consumer Benefits

- Govindarajan and Anthony (continued)
  - Concluded that "in the real world most large companies use full costs rather than variable costs"
  - Concluded that the results of their survey "unequivocally destroy… the myth that full costs, and especially allocated costs, are irrelevant as a basis for pricing decisions…"

Price-Related Consumer Benefits

- Shim and Sudit
  - 1995 survey of 600 large industrial companies
    - 141 respondents
    - 36 percent based prices on total cost
    - Additional 34 percent based prices on total production costs
    - Only 12 percent based prices on variable costs
  - Consistent with findings of Govindarajan and Anthony

Price-Related Consumer Benefits

- Cost-based contracts and contracts allowing for cost audits
- Many bid situations (e.g., construction trade)
- Pricing decisions tied to gross profit thresholds
- Knowledgeable power buyers who force lower prices

Price-Related Consumer Benefits

- May provide management the latitude to undertake price cutting
  - Firm management is under continuous pressure to maximize short-term earnings
  - Fixed and variable costs have equal footing in reported profits
  - Fixed costs savings may provide the cushion to undertake price cutting that produces “short-term” earnings consequences but offers long-term growth prospects

Price-Related Consumer Benefits

- Managers responsible for setting prices may be accountable for attaining a target level of profitability that includes fixed and allocated costs
  - Managers may not have control over or knowledge of the breakdown between fixed and variable costs
  - Product and brand managers often operate as profit centers and price off total costs
  - Studies of firm pricing often cite lack of time, resources and information needed by managers to determine optimal pricing
- Transfer pricing situations
  - Lower fixed costs may affect transfer price for inter-company goods and services

Typical Brand Manager P&L Statement

	Year 1	Year 2	Year 3
Sales	$70,000	$72,000	$75,000
Raw Materials	21,000	21,600	22,500
Other Variable Mfg Costs	9,800	10,080	10,500
Fixed Mfg Costs	15,500	15,750	16,000
Gross Profit	23,700	24,570	26,000
Marketing Expense	4,200	4,350	4,500
Research & Development	1,200	1,250	1,300
Corp Administration	2,000	2,100	2,200
Divisional Administration	750	825	900
Property Taxes	375	375	375
Operating Profit	17,650	15,670	16,725
Capital Expenditures	10,500	5,750	7,500
Working Capital	2,500	3,250	4,000
Net Cash Flow	$4,650	$6,670	$5,225

Price-Related Consumer Benefits

- May enable companies to sustain or extend the duration of below-cost price competition or to intensify below-cost pricing competition
  - May enable firms engaged in below-cost price competition to continue investments in R&D, new product development & other consumer-oriented services
  - May limit the extent to which paring of least profitable products or customers is undertaken by firms engaged in below-cost price competition
  - Commentators note that firms that face aggressive pricing often adjust by reducing other competitive activities

Price-Related Consumer Benefits

  - May delay or reduce the risk of market exit by firms engaged in extended below-cost pricing
    - The result of many "price wars" is relegation of losers to niche markets or exit from the market
- Incremental investments made possible by fixed cost savings may themselves result in lower variable costs which lead to lower prices
  - There can be many such investments, including "make / buy" decisions
    - Fixed cost savings may justify moving outsourcing in-house
    - Outsourcing of production generally gives rise to a variable cost, whereas internal production has both fixed and variable components
    - Reduction of variable cost may lead to lower prices

Non-Price Consumer Benefits

- Do fixed cost savings benefit shareholders exclusively?
  - Perception that fixed cost savings only benefit shareholders is erroneous
  - Rationale behind most mergers is not to distribute fixed cost savings to shareholders, but rather to invest in business
  - Reinvestment in business increases firm value and leads to consumer benefits

Non-Price Consumer Benefits

- Increasing share of earnings retained and invested productively in the business
  - Studies show that dividend rates have declined
    - Average dividend yields have fallen from 5-6% in the mid-1970's to approx. 1.25% in 2001
  - Studies show that percentage of companies paying dividends has declined dramatically
    - From 66.5% in 1978 to 20.8% in 1999

Non-Price Consumer Benefits

- Studies indicate that the propensity to pay dividends declined between 1978 and 1998 for firms with high investment outlays
  - Dividend ratios inversely related to expected investment outlays

Non-Price Consumer Benefits

- Reduced leverage
  - Fixed cost savings contribute cash that can be used to reduce leverage
    - High debt levels limit investment
    - Studies show lower growth rates and higher prices for highly-leveraged companies

Non-Price Consumer Benefits

- SEC filings typically point out limitations imposed by high leverage
- Increased vulnerability to adverse economic and industry conditions
- Limited ability to fund future working capital, capital expenditures, research and development costs and other general corporate requirements
- Limited flexibility to plan for, or react to, changes in the business and the industry
- Increased interest expense that might have to be paid because some borrowings are at variable rates of interest
- Limited ability to borrow additional funds, particularly in light of financial and other restrictive covenants of existing indebtedness

Non-Price Consumer Benefits

- Lower average cost of capital
  - Improved credit ratings
    - Credit ratings driven by forecasts of cash flow and related ability to meet financial commitments and adequately fund the business
    - Improved credit ratings result in lower-cost capital
  - Antitrust scholars acknowledge the importance of capital-savings efficiencies
    - Large companies enjoy significantly lower borrowing costs
    - Cost of capital disadvantage leads to competitive disadvantages

Non-Price Consumer Benefits

- Internal source of readily accessible funds
  - Internal capital is primary source of funding for business operations
  - External debt and equity sources generally have associated transaction costs and often-long lead times
  - Without adequate profit and cash flow, external capital more costly to attract

Non-Price Consumer Benefits

- New product development
  - Fixed costs generally taken into account in decisions regarding new product development
    - Investment decision premised on total costs over the life expectancy of the product
    - From brand or product manager's standpoint, costs include ongoing fixed costs and allocated costs
    - Fixed cost savings may enhance investment decision by reducing fixed and allocated costs associated with decision
  - Product life cycles are becoming shorter and new product development crucial to success
    - Studies show that the development of new products and services is becoming the primary source of sustainable competitive advantage

Non-Price Consumer Benefits

- Examples of industries where new product development is of major importance
  - Automobiles
  - Biotechnology
  - Consumer and industrial electronics
  - Computer software
  - Pharmaceuticals
  - Food and other consumer goods
  - Firms within these and similar industries invest proportionately larger sums into R&D

Non-Price Consumer Benefits

- Improved success rate for new products
  - Savings can be used to fund investments in employee training and information technology
  - Savings can contribute to new product efforts by subsidizing failure rates
    - Studies show that many R&D projects never result in commercial product and between 33 percent and 60 percent of all new products that reach market fail to generate an economic return

Non-Price Consumer Benefits

- Bring new products to market quicker
  - Studies conclude that speed to market is critical for business success
  - Fixed cost savings can contribute to intensified capital investment aimed towards shortening new product development cycles and introducing new products more quickly into the marketplace

Non-Price Consumer Benefits

- Other potential consumer benefits from fixed cost savings include
  - Provide funding for increased advertising, product promotion and customer services
- In sum, fixed cost savings provide funds for internal growth opportunities, asset replacement, and ongoing investment in the business
  - Non-price consumer benefits from fixed cost savings "multiply" by diffusion to competing firms

Credit Should Be Accorded On a Case-By-Case Basis

- When should fixed cost savings count?
  - Judge the potential impact of fixed cost savings on prices within the market
  - Judge weight to be given to non-price consumer benefits by assessing the value of such benefits within the relevant market

Credit Should Be Accorded On a Case-By-Case Basis

- Accord more credit in markets where competitors have a more efficient cost structure
- Assess the effect of fixed cost savings to the merged firm's cost of capital
- Assess merged entity's growth intentions
- Determine merged firm's historical use of excess cash flow

Credit Should Be Accorded On a Case-By-Case Basis

- Responsibility for demonstrating consumer benefits rests primarily with the merging parties
  - E.g., AmeriSource Bergen
    - Lower cost of capital
    - Accelerated repayment of debt
    - Empirical studies showing lower growth rates and higher prices of highly-leveraged companies
    - Evidence of higher business failure at pre-merger credit ratings
    - Evidence that Bergen declined to bid or service certain customers and pared customer accounts due to capital constraints
  - Notwithstanding, antitrust authorities should undertake inquiry into potential consumer benefits from fixed cost savings

Sources of Information Relevant to an Assessment of Fixed Cost Savings

- Business unit P&Ls, budgets and forecasts and financial targets to determine extent to which managers are accountable for covering fixed and allocated costs and what benefits may be derived from fixed cost savings
- Capital authorization requests, investment proposals and pro forma business unit P&L's to determine the relevance of fixed costs in investment decisions and the potential of fixed cost reductions to enhance future investment proposals
- Historical financial statements to assess the company's debt position and the likely impact of fixed cost savings on the merged firm's cost of capital and internal hurdle rates
- Pricing models to gain an understanding of company's pricing methodology and extent to which reductions in fixed costs might impact pricing decisions
- Business and marketing plans to determine the extent to which managers and sales and marketing personnel are accountable for full costs
- Cost allocation methodologies to determine the basis for cost assignments to specific products and business units and potential impact on future investment proposals

Summary

- Fixed cost savings can provide direct price-related consumer benefits
- Fixed cost savings can provide or contribute to important non-price consumer benefits
- Determination of the importance of fixed cost savings should be made on a case-by-case basis
- Primary responsibility for demonstrating consumer benefits from fixed cost savings rests on the merging parties

Efficiency Claims Experience

- Merger Guidelines
  - -- Merger Specificity
  - -- Verifiability
  - -- Cognizable
- What We Would Like
- What We See
- How To Provide

Merger Guidelines

"*Cognizable efficiencies* are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service." Horizontal Merger Guidelines p. 31

Merger Guidelines

Merger Specific – "*…*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 anti-competitive effects." Horizontal Merger Guidelines p. 30

Merger Guidelines

"*…*efficiencies*…*,which enable the merging firms to reduce the marginal cost of production, are more likely to be [cognizable]." Horizontal Merger Guidelines p. 32

Merger Guidelines

"The Agency also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market."
Horizontal Merger Guidelines p. 32

Merger Guidelines

"*…*the merging firms must substantiate efficiency claims so that the Agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific."
Horizontal Merger Guidelines p 31