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FEDERAL TRADE COMMISSION
DEPARTMENT OF JUSTICE
JOINT WORKSHOP ON MERGER ENFORCEMENT

Tuesday, February 17, 2004
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Federal Trade Commission
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OPENING REMARKS

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4 MR. ABBOTT: Good morning, everyone. Welcome
5 to the Joint Federal Trade Commission Department of
6 Justice Antitrust Division Workshop on Merger
7 Enforcement. This workshop will be held here today in
8 the new FTC conference center -- and we hope you all
9 enjoy the facilities -- for today, tomorrow, and
10 Thursday.

11 We welcome members of the audience to listen
12 in, although all questions during the proceedings will be
13 handled by members of the panels.

14 We will start out today -- and I am not going
15 to go into thanks, but I owe a debt of thanks to staff at
16 both the Federal Trade Commission and the Antitrust
17 Division, and certainly Bob Potter, head of the policy
18 office of the Antitrust Division, for tremendous
19 collaboration and support in putting on this event, which
20 we hope will clarify a number of issues regarding the
21 current application of the merger guidelines.

22 And we are delighted to start things out with a
23 bang with the leaders of the federal antitrust community.
24 We will lead off with brief remarks by Assistant Attorney
25 General Hew Pate, and follow up with remarks by FTC

1 Chairman Tim Muris.

2 And both General Pate and Chairman Muris have
3 quite a few significant accomplishments, but I won't take
4 away from their important time at the podium by going
5 into them. Suffice it to say that they are welcoming
6 you, and also to the audience that is listening in on the
7 800 telephone line to this important conference.

8 And we hope to obtain some valuable information
9 which will inform our activities in the future, as a
10 result of the conference. So, let me turn it over right
11 now to General Pate.

12 MR. PATE: Thanks very much, Alden. Thanks to
13 the Federal Trade Commission for providing this great
14 facility to host our look into the operation of the
15 merger guidelines, and to consider improvements -- we
16 hope -- in thinking, or developments in thinking, in the
17 way that the agencies carry out their responsibilities
18 under Section 7 of the Clayton Act and under the FTC
19 statute.

20 I think that it's fair to say that this is one
21 part of a very significant amount of policy activity
22 that's going on at the two agencies. And frankly, I
23 think Tim Muris deserves the lion's share of the credit
24 for that, in terms of bringing forward the concept of
25 joint work between the two agencies.

1 That has been producing a great deal of
2 thinking, in terms of the IP and antitrust hearings,
3 which are now drawing toward a final close, hopefully
4 with the publication soon of the antitrust and IP report.
5 That's happening in the health care antitrust arena, in
6 the context of the hearings that were held there, and
7 this merger conference is yet another example.

8 Both of the agencies, likewise, have been
9 active individually on the policy front. I think of the
10 report on patent practices and procedures, that the Trade
11 Commission has issued, which is a very important
12 document, and likewise, in just a few weeks we at the
13 Division will be heading up a conference looking at
14 pricing practices.

15 And I think all of this is really an important
16 part of our mission, and I want to thank and acknowledge
17 my colleagues at the Federal Trade Commission, starting
18 with Tim, for putting in place the circumstances that
19 have made for a very good relationship there.

20 Obviously, at the Division, merger enforcement
21 is a key part of our mission. Depending on the activity
22 level, it might be fair to say that roughly one-third to
23 two-thirds of our effort goes into merger enforcement.
24 As I have mentioned elsewhere, merger enforcement is
25 different from some of the other things that we do in the

1 antitrust world, certainly different from cartel
2 enforcement, where there is little or no serious
3 controversy about the need to aggressively intervene
4 where cartel activity is detected.

5 It is different, too, from the unilateral
6 conduct sphere, where it's very important for the
7 agencies to have a very high degree of caution about
8 where they intervene, because of the possibility of
9 chilling competitive conduct in the guise of combating
10 anti-competitive conduct.

11 Obviously, it's a gross over-simplification,
12 but I suggest that merger enforcement falls somewhere in
13 the middle, that there is a broad consensus about what we
14 are trying to achieve, but plenty of room for debate and
15 discussion about what the best use of the tool set that
16 we have to evaluate mergers.

17 Obviously, merger enforcement requires us to
18 make predictive judgments. Section 7 is described often
19 as an incipency statute. That's obviously true, but
20 that term can carry different, very freighted meanings,
21 depending on who the speaker might be.

22 And what we're about here is to try to
23 determine how best we can make predictive judgments about
24 proposed transactions to make sure that those that would
25 bring efficiency and better outcomes for consumers are

1 allowed to go forward. And likewise, that those that
2 have the real prospect for substantial lessening of
3 competition don't happen.

4 Obviously, the Horizontal Merger Guidelines are
5 the Agency's most important statement of how we go about
6 doing that. The merger guidelines of 1982, which have
7 been revised now several times -- in 1984, 1992, 1997 --
8 revised with some significant language changes, and some
9 significant changes in approach.

10 Certainly the agencies, even apart from those
11 textual changes, have, throughout this period,
12 incorporated advances in economic thinking and
13 improvements in our own practices and learning.

14 The guidelines are flexible, they are
15 practical. At the same time, I think it's fair to say
16 that both agencies are in a period of trying to emphasize
17 transparency. It may not be quite enough simply to say
18 that those in the bar who are very experienced repeat
19 customers of the agencies have a good idea of how we do
20 things, but rather that we have an obligation to be as
21 transparent as possible to the public generally.

22 You can see that in terms of the increased
23 incidents of the issuance of closing statements at both
24 agencies, to try to give some amount of guidance to the
25 public, when we decide that government intervention is

1 not warranted.

2 And I think you can see that in terms of the
3 release of data that has preceded this conference. The
4 agencies jointly, as you know, have released data on
5 merger challenges from 1999 to 2003.

6 The Federal Trade Commission has now released
7 significant data on cases in which a challenge was not
8 brought, and also issued some data that shed light on
9 other factors, customer complaints, hot documents, other
10 things that the agencies looked at in evaluating a
11 proposed merger. And we hope very much that this will
12 set the stage for some very interesting discussion and
13 improved learning in this conference.

14 Transparency, as I have said, is important, not
15 only for the repeat players in the merger bar who are
16 likely to be most interested in this, but for other
17 enforcers, both here and internationally. I think that
18 we need to be very mindful, not only of enforcing in a
19 sound way, but explaining what sound enforcement entails.

20 Whether we like it or not, the two federal
21 agencies are not the only game in town in terms of how
22 merger policy is going to go forward, and it's incumbent
23 on us to show our reasoning and be part of the broader
24 discussion of what appropriate enforcement criteria are.
25 And I hope this conference will contribute to that.

1 We certainly have a wide range of topics and a
2 wide range of speakers, most of whom are very familiar to
3 anyone who is involved in merger policy. If we had an
4 antitrust ego-meter to put up here on the podium during
5 the next three days, it would break.

6 Fortunately, we have got some very good
7 moderators, mainly from the two agencies, who have put a
8 great deal of time into preparing to keep these panels
9 under control and hope to get some insight from them.

10 One thing you might ask is, "What is our goal
11 here?" Well, it's certainly not the case that this
12 conference has been called because anyone thinks
13 something is broken. Nor is it the case that the
14 conference has been put together because there is some
15 pre-ordained goal of producing any particular output from
16 the conference. I think that's a question that we're not
17 really in a position to answer until we get the benefit
18 of hearing what reactions and thinking, based on the data
19 that's released, based on work that many of the panels
20 have done independently over the past several years.

21 Until we hear that, it's hard to say whether
22 and what might come next. But just as with the process
23 side, where both agencies have done a good deal to try to
24 improve our procedures, this conference does demonstrate
25 our open-mindedness to try to make sure that we are

1 keeping up with the best thinking on substance.

2 So, with that, I will conclude simply with a
3 very big thank you to those at both agencies who have put
4 a great deal of time into organizing these panels. I
5 look forward to participating in some more of this,
6 including a round table Thursday afternoon, and will keep
7 things moving now by introducing my good friend, Tim
8 Muris, for his opening remarks to help us kick off the
9 conference. Thanks very much for being here.

10 (Applause.)

11 MR. MURIS: Thank you very much, Hew. It is
12 certainly a pleasure to be here. This should be an
13 interesting three days. Hew and the Department of
14 Justice are, obviously, our most important partners and
15 colleagues, and I greatly appreciate their help and work
16 on their effort.

17 And I wanted to thank our staff at the FTC and
18 the Justice Department staff. The data we released,
19 which I will discuss briefly here in a second, is quite
20 interesting, and I am sure many of those who will be
21 talking over the next few days will remark on that data.

22 I particularly wanted to thank our economist
23 who worked on that data. It was a lot of work. I see a
24 few of them out there in the audience. It required a lot
25 of people to read a lot of our memoranda from the past.

1 It is certainly a pleasure to me, and an honor,
2 that -- I noticed Hew's interesting comment about the
3 ego-meter -- that we will have so many prominent
4 practitioners, academic and enforcement officials here
5 over the next few days.

6 I won't repeat the mistake I made about a
7 decade ago, when I was at a gathering of -- a conference
8 with many of the leading economists, and I was on a
9 panel, and I said, "This is the greatest gathering of
10 \$500-an-hour economists every assembled." This was a
11 long time ago when billing rates were lower. And one of
12 them took great offense, and it was immediately obvious
13 to me and everyone else that this person billed
14 considerably higher than \$500 an hour.

15 (Laughter.)

16 MR. MURIS: And the others were all making
17 notes. And I felt like a facilitating practice, so --

18 (Laughter.)

19 MR. MURIS: As Hew mentioned -- you know, well,
20 whatever one's billing rate -- we are going to discuss
21 the impact of the guides. And as Hew mentioned, they
22 have an impact not only at the federal level, but also at
23 the states and internationally.

24 There are over 60 countries that have merger
25 control regimes, and you can see the influence on the

1 guidelines almost everywhere.

2 Let me tell you what my view of what we can
3 achieve over the next three days. The guidelines, as I
4 think we all know, are not a cookbook. They don't
5 provide specific details on every aspect of a merger
6 investigation. They do detail a methodology, whether to
7 analyze -- to analyze whether a merger is likely anti-
8 competitive. And what the workshop is going to do is
9 explore state of the art application of the guidelines by
10 those with the most experience at using them.

11 We will publish an edited transcript on our
12 website so that people can refer to it. I know there are
13 a lot of people at the FTC -- I'm sure at Department of
14 Justice -- listening on their computers. There are other
15 people listening on their 800 number. We are actually
16 going to film this so I can watch it on my exercise bike,
17 and other people can refer to it as well.

18 As Hew mentioned, we at the FTC have also
19 emphasized transparency over the 32 months that I have
20 been at the Commission. We have released statements in
21 several cases in which we did not sue, including three
22 cases very recently.

23 We have released the two data sets that Hew
24 mentioned. The first one contained market share and
25 concentration levels associated with the FTC and DOJ's

1 decisions to challenge mergers in a wide range of product
2 markets. And then a few weeks ago, the FTC released data
3 on 151 horizontal merger investigations from the
4 beginning of fiscal year 1996 through the end of fiscal
5 year 2003.

6 Unlike the December data, this release included
7 data when no enforcement action was taken, as well as
8 data on additional key facts. One statistic we released
9 involved the numbers of significant competitors. Many
10 practitioners I know think and talk in these terms,
11 rather than concentration.

12 These data also look at enforcement decisions,
13 depending on whether hot documents exist or strong and
14 credible customer complaints are received. These data
15 should become core information in a healthy debate about
16 the level and direction of merger policy.

17 I note that our recent data released largely
18 reflects cases in which I did not participate. Indeed, I
19 participated in cases involving only about 10 percent of
20 the markets analyzed.

21 As I have said elsewhere, current merger
22 practice reflects a bipartisan approach. And the release
23 of this and similar data in the future should help us
24 understand merger enforcement in practice.

25 The data we released highlights several

1 important issues in merger analysis. One involves the
2 long-standing debate about the significance of
3 concentration and HHI numbers. I hope the data we
4 released and the breadth of analysis we will hear this
5 week will finally put to rest the notion that HHI levels
6 have any special significance, except at very high
7 levels.

8 Instead, the agencies try to answer the
9 ultimate question. Will the merger impair competition?
10 We consider several variables that have an impact on the
11 likely level of competition in post-merger markets.
12 Fealty to the original guideline numerical levels was
13 abandoned as the agencies gained experience. In 1992,
14 the guidelines were amended to codify the existing
15 practice of giving great weight to qualitative factors.

16 The 1982 and 1984 guidelines had given more
17 emphasis to quantitative thresholds, particularly
18 involving HHI levels above 1800. I remember Jim Miller
19 and Bill Baxter discussing what the appropriate levels
20 ought to be, and it was clear to me from those
21 conversations that Bill retained some of his views that
22 he had expressed in the 1960s about the strong
23 presumptions one could gather from concentration.

24 In any event, the 1992 guidelines reduce the
25 significance of the 1800 threshold by inviting fuller

1 consideration of other conditions that help predict
2 whether price increases are likely, post-merger.

3 Thus, the pre-eminence that some would continue
4 to give to concentration or HHI numbers is misplaced.
5 State of the art merger analysis has moved well beyond a
6 simplistic causality of high concentration leading to
7 anti-competitive effects.

8 The number of competitors is certainly
9 important. Four to three gets our attention quicker than
10 six to five. But current merger practice does not
11 elevate a single fact or number to dispositive
12 significance. The totality of the evidence must point to
13 an increased likelihood of anti-competitive effects
14 before we act.

15 Much of this experience with merger
16 investigations is captured in the guidelines themselves.
17 One of the salutary effects that the guidelines have is
18 the transparency they help bring to government. They
19 help us clarify enforcement policy and doctrine so that
20 practitioners and their clients can make better
21 judgments.

22 Government officials should explain the basis
23 on which they exercise their authority. Stakeholders can
24 expect clear and consistent enforcement actions. Of
25 course, application of the guidelines is not always

1 obvious. Hence, the high billing rates.

2 We constantly strive to bring more transparency
3 to our merger process, and we hope this workshop will
4 result in a better understanding of current merger
5 policy. Equally important with providing increased
6 transparency for consumers in the business community is
7 the feedback this workshop should provide for the
8 agencies.

9 We want to obtain important information that
10 will assist us in doing our jobs. We thus expect to
11 learn from you over the next three days. We will hear
12 from the most experienced practitioners who work with the
13 guidelines every day, as well as academics doing state of
14 the art research. We want to know how you think the
15 guidelines are working, what you perceive to be their
16 strengths and weaknesses, what are the issues in which
17 there is agreement and disagreement, and what areas you
18 consider important for further study.

19 Research and clarification. Application of the
20 guidelines must respond to new legal and economic
21 analysis. With your help, we will continue that process
22 at this workshop. Thank you very much, and we can get
23 started.

24 (Applause.)

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HYPOTHETICAL MONOPOLIST TEST

MR. WERDEN: Good morning. I'm Greg Werden, and I am the moderator of this, the first session of the merger enforcement workshop, which focuses on the hypothetical monopolist paradigm for market delineation.

The hypothetical monopolist paradigm was elaborated, and certainly popularized, by the 1982 merger guidelines, but the basic idea was not original to the 1982 guidelines, as I think a lot of you realize. In the late 1970s, some of the Antitrust Division were already applying the test, and there is at least one documented example in print in 1978 to prove that I am right about that.

And I have uncovered antecedents much earlier than the 1970s. The following passage I'm going to read, and from which I have just edited out a few words to make it shorter, was written by Morris Adelman in 1953. "In asking, 'What is the market,' we must ask, 'What substitutes exist at what price for the product or service in question. Assuming that a single business concern were the only occupant of the allegedly separated market, would it have the power to raise price?' If the answer is yes, then the separate market exists within which competition can be lessened."

Well, that's the idea of a hypothetical

1 monopolist test, and I believe Adelman probably was the
2 first one to have it. His 1956 article has been quoted
3 more widely, but I just dug up this 1953 article last
4 year.

5 The 1982 merger guidelines did a lot to develop
6 this basic idea into something quite useful for market
7 delineation. And revisions of the guidelines in 1984 and
8 1982 fine tuned that approach. Our panel today is going
9 to draw on experience of 20 years plus in applying the
10 hypothetical monopolist test, and offer insights on
11 possibilities for refining its application further.

12 I won't waste any time on introductions of our
13 speakers, I will just turn things over to our first
14 speaker, John Harkrider.

15 MR. HARKRIDER: Thank you, Greg. The
16 hypothetical monopolist test is one of the organizing
17 principles of the horizontal merger guidelines. And it
18 is a test that is increasingly applied to define markets,
19 not just in merger cases, but throughout antitrust. And
20 not just in the United States, but throughout the world.

21 But the hypothetical monopolist test is not
22 "flawless." Indeed, three years after the 1982
23 guidelines were published, a leading IO economist
24 commented that, "The guidelines market definition test
25 has one wholly decisive defect. It is completely non-

1 operational."

2 (Laughter.)

3 MR. HARKRIDER: Well, history has proved that
4 that concern is overstated, as there clearly are data and
5 quantitative methods that will operationalize the
6 hypothetical monopolist test.

7 It is important to note that using reliable
8 data is critically important. Because without such data,
9 we quite frequently resort to the Brown Shoe factors that
10 the hypothetical monopolist test was meant to supersede,
11 or at least clarify.

12 My remarks address how to render the
13 hypothetical monopolist test operational by using sound,
14 empirical methods that answer the question posed by the
15 guidelines market definition test.

16 At the outset, it's important to realize that
17 the hypothetical monopolist test asks two subsidiary
18 questions. The first is, what volume of lost sales will
19 make a SSNIP unprofitable? And second, what volume of
20 sales will, in fact, be lost as a results of a SSNIP?
21 Much of the economic literature has focused on the first
22 question. And that is, in fact, the question that
23 critical loss attempts to answer.

24 The second question, however, what volume of
25 sales will be lost as a result of SSNIP is frequently not

1 answered. And as a result, a fact-finder, whether an
2 agency or a court, may have confidence that a
3 hypothetical monopolist could not profitably impose a
4 SSNIP if it were to lose X percent of its sales. But
5 that fact-finder may have no confidence that the
6 hypothetical monopolist would lose more or less than X
7 percent of its sales.

8 The purpose of these remarks is to provide some
9 guidance towards answering the second question: What
10 volume of sales would the hypothetical monopolist lose if
11 it were to impose a SSNIP. To that end, we will discuss
12 four forms of evidence: historical evidence; econometric
13 evidence; affidavit evidence; and survey evidence.

14 The merger guidelines expressly authorize the
15 use of historical data, although they have cautioned it
16 may produce misleading results. Past price changes will
17 often reflect changes in cost affecting the whole
18 industry, rather than market power. And consumers'
19 reactions to such changes do not illuminate how they
20 would respond to a hypothetical monopolist.

21 Moreover, price changes typically are of short
22 duration, and thus do not satisfy the non-transitory
23 requirement of the SSNIP test. For that reason, the
24 guidelines themselves caution that the picture of
25 competitive conditions that develops from the use of

1 historical evidence may provide an incomplete answer to
2 the forward-looking inquiry of the guidelines.

3 When considering historical evidence, it is
4 important to distinguish between two types of evidence.
5 First, evidence that consumers switched in response to
6 past price changes, and second, evidence that consumers
7 did not.

8 If a significant number of consumers switch
9 from Product X to Product Y in response to a small but
10 significant price change in X relative to Y, this seems
11 to be evidence that the two belong in the same relevant
12 market.

13 The criticism that the price change on X may be
14 cost justified or not sufficiently long in duration would
15 simply suggest that even more consumers may switch from X
16 to Y if the price increase were not cost justified,
17 imposed by monopolists, or of longer duration.

18 Alternatively, evidence that customers did not
19 switch from product X to Y in response to a small but
20 significant price change in X relative to Y, may have
21 little bearing on whether the products belong in the same
22 relevant market, as customers may be more likely to
23 switch if the price increase were not cost justified,
24 imposed by a monopolist, or of longer duration.

25 Another form of historical evidence are natural

1 experiments. In an extreme case, if the firm is selling
2 the products in the proposed market, and had in the past
3 engaged in cartel activity, there should be little reason
4 to doubt that the market is properly defined.

5 One court wrote that, "Every price-fixing
6 conspiracy thus identifies directly, in a real-world
7 context, a group of firms which is insulated from outside
8 competitive pressure." This is precisely what
9 conventional market definition evidence attempts to
10 identify artificially.

11 Another example of a natural experiment is the
12 court's analysis in Staples. In that case, the FTC's
13 various price studies which, on the whole, the court
14 found persuasive, tended to show that a hypothetical
15 office superstore monopolist could impose a SSNIP on the
16 sale of consumable office supplies, because when it was
17 an actual office superstore monopolist, that is precisely
18 what it did.

19 A form of historical evidence is econometric
20 evidence. Econometric evidence uses historical evidence
21 in a controlled and scientific manner to answer the
22 hypothetical monopolist test.

23 In fact, Judge Easterbrook, just a few weeks
24 ago, in Menasha Corp v. News Corp criticized a plaintiff
25 for failing to introduce econometric evidence of any kind

1 in defining the relevant market.

2 There are many types of econometric analysis
3 that can be used to answer the hypothetical monopolist
4 test. One type of the sort used in Staples, which, in
5 effect, allows for a controlled natural experiment. This
6 type of analysis requires geographic variation as to the
7 number of competitors, as well as information on pricing,
8 number of competitors, and factors that may influence the
9 price of goods.

10 A second type of analysis directly estimates
11 market elasticities. To be done properly, this type of
12 analysis requires time series consumer-level information
13 on price and quantity. While there is general agreement
14 that in appropriate circumstances, econometric estimates
15 of elasticities can provide perhaps the best evidence as
16 to market definition, there are significant issues with
17 respect to its use.

18 One issue involves the ability of data. It is
19 quite unusual for private parties to have access to price
20 and quantity information from all market participants.
21 This is, of course, less of an issue for the government,
22 but it raises important issues about transparency, as the
23 government may be unable to share this data typically
24 collected through the CID process with the merging
25 parties.

1 A second issue involves the quality of the
2 data. For example, retail scanner data, which is one of
3 the few forms of time series data that is available,
4 frequently does not give sufficient information on
5 coupons or other discounts. And so your economist needs
6 to opine on whether that level of competition is
7 important.

8 A third issue involves the appropriateness of
9 the data. Retail scanner data, for example, may not be
10 the appropriate type of data to analyze mergers between
11 manufacturers.

12 If you want to know what somebody would do in a
13 hypothetical situation, one alternative simply is to ask
14 them. This may explain the practical appeal of the
15 guideline's 5 to 10 percent price increase formulation of
16 the SSNIP test. It gives lawyers and economists a
17 concrete question to ask customers in interviews and
18 depositions. It also has led to the frequent use of
19 customer affidavits and merger litigation.

20 There are, however, significant issues with
21 respect to the use of customer affidavits. Areeda and
22 Turner go so far to suggest that customer affidavits are
23 "the least reliable evidence of whether consumers would
24 switch in response to a SSNIP."

25 Despite this criticism, the government and

1 litigants in merger cases frequently use affidavits. A
2 review of cases involving the use of affidavits revealed
3 two frequent errors. First, affidavits frequently ignore
4 the presence of switching costs. And second, affidavits
5 frequently do not cover a representative sample of
6 consumers.

7 As to the first question, if consumers will not
8 switch between the products being grouped together for
9 the purposes of applying the hypothetical monopolist
10 test, it may not be meaningful to ask whether they would
11 switch to a product outside of the proposed market
12 following a SSNIP. For example, in Englehard, the DOJ
13 argued that current GQA customers would not switch to
14 alternatives in response to a SSNIP in GQA was evidence
15 that there existed a relevant market for GQA.

16 However, the 11th Circuit rejected the DOJ's
17 argument in part because Englehard's GQA customers would
18 not switch to other sellers of GQA in response to a SSNIP
19 in the price of Englehard's GQA.

20 The guidelines acknowledge a variation of this
21 point when they speak of adjusting the size of a SSNIP to
22 account for situations where the relevant product
23 constitutes a small percentage of the overall cost of the
24 goods or service.

25 Affidavits also must cover an adequate sample

1 of customers, and it's important to consider this point
2 in the context of critical loss. Consider, for example,
3 you hire Barry Harris, and he tells you that in response
4 to a SSNIP, a hypothetical monopolist would find it
5 unprofitable if it lost 8 percent of its sales.

6 Then, imagine the government goes out and
7 interviews 100 customers, randomly selected -- which, it
8 is doubtful, that that is the case, but let's say that
9 they interview 100 random customers. And let's say that
10 92 of them say that they wouldn't switch and eight of
11 them say that they would. And let's assume that all the
12 customers purchase an equal level of the good. In that
13 case the government may very well win.

14 Now, the government frequently doesn't have a
15 random sample. And so, when you think of it this way, if
16 the government has 100 affidavits or 200 affidavits, or
17 if a private party has 100 or 200 affidavits, that may
18 not be meaningful if there are, of course, more than 100
19 or 200 customers out there.

20 And two cases make this very point. In
21 Englehard, the 11th Circuit said, "It is possible that
22 only a few customers who switch to alternatives to make
23 the price increase unprofitable, thereby protecting a
24 large number of customers who would have acquiesced to
25 higher GQA prices."

1 No matter how many customers in each end-use
2 industry the government may have interviewed, those
3 results cannot be predictive of the entire market if
4 those customers are not representative of the market.

5 In SunGard, the court made a similar point.
6 The court wrote: "The sampling of customer statements
7 before the court is minuscule when compared to the entire
8 universe of defendant's shared hot site customers.
9 Although the government has submitted approximately 50
10 statements from customers stating that they either would
11 not or could not switch from shared hot sites, there were
12 more than 7,500 customers that currently used defendant's
13 shared hot sites. Without more information, the court
14 simply cannot determine whether these 50 declarations are
15 representative of the shared hot site client base."

16 In some instances, a few customers, however,
17 may be able to speak to the overall demand elasticities
18 of an industry. For example, in Swedish Match, the FTC
19 may have avoided the sampling problem when it used
20 affidavits of looseleaf chewing tobacco distributors as a
21 proxy for the views of a broad spectrum of customers.

22 The last form of evidence I want to talk about
23 is survey evidence. A frequent criticism of consumer
24 affidavits is that they are form affidavits, which simply
25 give yes or no responses to a series of questions,

1 including whether a customer would switch in response to
2 a SSNIP. Well, that may not be an affidavit; what it
3 really may be is a survey.

4 And so, if the goal of a client is simply to
5 obtain as many affidavits as possible without taking the
6 time to create detailed, customer-specific affidavits, it
7 may be advisable to conduct a survey instead. Indeed, if
8 conducted properly by an expert trained in acceptable
9 survey methodology, surveys should carry more weight than
10 even an allegedly representative sample of affidavits.

11 For example, surveys may have more
12 methodological controls concerning leading questions,
13 selection bias and randomness. Surveys may also make it
14 easier to organize customers by key competitive traits,
15 reflecting the probable elasticities of their demand.
16 And perhaps, as an added benefit, it's very difficult for
17 the government to depose survey respondents.

18 For the hypothetical monopolist test to serve
19 as something more than an instructive theoretical
20 paradigm, litigants, agencies, and courts should look to
21 empirical evidence that can directly answer the question:
22 How many customers will switch in response to a SSNIP?

23 Well, historical evidence, affidavits,
24 econometric evidence, and survey evidence can all be
25 subject to criticism. There can be little question that

1 they are better than conjecture on what is a critical
2 question on market definition.

3 MR. WERDEN: Thank you, John. And now the
4 cross-examination phase.

5 MR. HARKRIDER: Do I sit over there for this,
6 or --

7 MR. WERDEN: Wherever you like. You're
8 supposed to stand in the dock, I believe, as the
9 defendant.

10 MR. HARKRIDER: Fair enough.

11 MR. WERDEN: I am intrigued by your suggestion
12 that we should care whether price increases are cost-
13 justified in examining historical evidence of how
14 customers reacted to price changes.

15 I don't know how customers would know, and I
16 don't know why they would care, whether price increases
17 are cost-justified. So, would you elaborate your
18 thinking on this subject?

19 MR. HARKRIDER: Yes. I'm not sure if it's
20 particularly important whether they are cost-justified or
21 not. The point I'm trying to make is that prices
22 frequently change in an industry. And in response to
23 those price changes, which may very well be cost-
24 justified price changes, you need to look at that context
25 of a price change in order to determine whether it's

1 instructive on the hypothetical monopolist test.

2 I'm not sure if I'm making a significant point
3 as to whether they're cost-justified or not, just simply
4 pointing out that they may very well be cost-justified.

5 MR. WERDEN: Okay. Let's turn to your
6 suggestion that somehow switching costs have to be taken
7 into account in market delineation. Let me give you a
8 very simplistic hypothetical, because any real case is
9 way too hard to do in the time we have.

10 Let's suppose that all the current users of a
11 product are totally locked in, but there are new users.
12 The hypothetical monopolists might be limited to
13 exploiting the current users, and giving up on any new
14 customers, or might be able, in some circumstances, to
15 discriminate between the two.

16 In either event, my question is: Is there any
17 way that the presence of switching costs would cause you
18 to depart from the standard 5 or 10 percent price
19 increase as the significance threshold for market
20 delineation?

21 MR. HARKRIDER: Yes, I think you make an
22 interesting point, and I think the court in Englehard
23 makes this very point. When you're dealing with
24 customers that may be locked in, the dynamic of
25 competition you may want to be looking at is the

1 competition for new customers. I think that's the first
2 point.

3 I think the second point is that in order for
4 any test or hypothesis to have any meaning, I think a yes
5 answer needs to mean something different, or lead to a
6 different conclusion than a no answer.

7 So, if you ask someone whether they would
8 switch in response to a SSNIP to another product that you
9 believe is in the relevant market, and you ask them the
10 same question with respect to a product that is not
11 within the relevant market, and the answer to both of
12 those questions is no, they would not switch, in order
13 for that test to have meaning you cannot reach different
14 conclusions with respect to whether one is in the
15 relevant market or the other one is in the relevant
16 market.

17 So, if the customer would not switch -- in
18 response to a SSNIP -- to another product in the relevant
19 market, I think you need to take into account switching
20 costs. You need to be able to get a yes answer to
21 products that were within the relevant market and a no
22 answer to products that are not within the relevant
23 market, or the test -- or the question has no meaning.

24 MR. WERDEN: Well, frankly, I just don't
25 understand why that is so. This evidence may suggest

1 that there isn't any competition between the merging
2 firms, and that would be an interesting thing, if that
3 was the conclusion.

4 But that's not what we're asking when we're
5 delineating the market. We are asking whether a
6 hypothetical monopolist would raise price significantly.
7 And I am really having trouble seeing how switching
8 between incumbent sellers of the relevant product who
9 are, by everyone's estimation, in the same relevant
10 market, how switching among them is relevant to the
11 question that market delineation poses.

12 MR. HARKRIDER: Well, I think you're actually
13 answering the question the same way that I would answer
14 it. I think the answer is no, it's not particularly
15 relevant, and so the point I was making is that
16 affidavits that ask the question that you say is not
17 relevant are probably not relevant to the issue of market
18 definition.

19 So, if the court -- if both the agency and the
20 court had focused on those customers that are not locked
21 in, I think that those are the questions that they should
22 have asked. But asking the hypothetical monopolist test
23 to customers that are locked in answers nothing, other
24 than the fact that these customers are locked in.

25 MR. WERDEN: It seems to me that the theory of

1 the case might be that the locked in customers will be
2 exploited, and that the merging firms will quit selling
3 to new customers. If that's the theory of the case, then
4 of course, evidence has to be mustered to show that
5 that's a sensible strategy after the merger.

6 But if that is so, then clearly the focus in
7 market delineation ought not to be on the new customer,
8 should it?

9 MR. HARKRIDER: Well, I think it's important --
10 I am an antitrust lawyer, and you're an economist. And
11 not to make that distinction, but the court in Englehard
12 certainly gave no weight to the affidavit statements,
13 because of the presence of switching costs.

14 And I think that unless you're arguing and can
15 persuasively argue that Englehard is wrong, I think that
16 it's very difficult to argue that switching costs don't
17 matter in that context.

18 MR. WERDEN: Well, I have it here.

19 MR. HARKRIDER: Okay.

20 MR. WERDEN: And I don't read it that way. But
21 we don't have time to go into it.

22 (Laughter.)

23 MR. WERDEN: So we're going to move on to our
24 next speaker, Barry Harris.

25 MR. HARRIS: Thanks, Greg. Two comments,

1 first. Just -- you mentioned about being in the dock. I
2 actually testified a few months ago, and there was a
3 federal judge in Rhode Island that actually makes the
4 witnesses stand.

5 And I didn't understand that, I thought the
6 chair was just missing, and I went to bring a chair over
7 when it was time to testify, and they told me, "No, we
8 don't do it that way, so you have to" -- and I guess it's
9 an incentive to give short answers.

10 But in any case, second thing, everyone is
11 talking about 20 years of experience. I am getting old.
12 I will be -- it was 30 years ago that I came to work for
13 the Antitrust Division, so I hope senility hasn't set in.
14 The one good thing about having done it so long is that I
15 am now able to do analysis by anecdote, so let me start
16 by telling a story about a hypothetical monopolist case.

17 I started working in the Antitrust Division in
18 October of 1974, and a year or two after that I was asked
19 to draft an affidavit on a case that I was working, a
20 merger case, for a possible challenge.

21 And I looked at some old affidavits, and as I
22 went through them I learned, "Hey, I'm supposed to define
23 a market." And being recently out of graduate school, I
24 didn't have a clue how to define the market. So I did
25 what seemed to me to be obvious, I went around and I

1 talked to senior lawyers and senior economists, and they
2 gave me a lot of different suggestions.

3 The lawyers gave me the Brown Shoe standards,
4 and some of the economists said, "Look at price
5 correlations." Some others said, "Look at cross-
6 elasticities." But none of the suggestions -- not one --
7 had anything to do with the actual exercise of market
8 power, it had to do with things that you might observe if
9 market power were being exercised, but it wasn't a kind
10 of a logical progression.

11 So then I finally did what I should have done
12 first, and I went to see my boss, who was George Hay, and
13 he suggested looking at it as a hypothetical monopolist.
14 And it was the first I had heard of it. I wasn't like
15 Greg, I hadn't gotten to reading books from 1952 in a
16 systematic way, and probably should have.

17 But in any case, once the question was put with
18 that type of framework, it all started to make a lot of
19 sense to me. And that ultimately gets to what is the
20 logic of the hypothetical monopolist principle. And at
21 least as I understand it, the point of it is simply to
22 identify a group of producers that would be able to
23 exercise market power if -- and this, for me, is a key
24 second part -- if they were able to coordinate their
25 pricing output decisions.

1 So, it's basically a two-step process. One
2 thing that I notice that I think often is not done
3 properly is that when you're considering whether or not
4 the group can coordinate, it seems to me you have to ask
5 what the nature of the coordination is going to be, and
6 it has to be consistent with the logic of what that
7 hypothetical monopolist is going to do.

8 In other words, as Greg points out, the basic
9 principle is would the hypothetical monopolist price in a
10 certain way and would it be profitable. Well, if you're
11 going to ask the questions about coordination, the second
12 step, it seems to me you have to go back to your
13 definition when you're doing your competitive effects
14 analysis.

15 Let me just reiterate that. The hypothetical
16 monopolist proposition tells you what the hypothetical
17 monopolists would do. You look at that, and then when
18 you do your competitive effects analysis it seems to me
19 it's incumbent upon you that you look at that in the
20 context of what that hypothetical monopolist would be
21 doing.

22 And let me give you an example. Let's say that
23 a hypothetical monopolist prices differentially -- so it
24 might be unilateral effects, might be something more
25 complicated than that. Analysis of that market must

1 consider the likelihood that the coordination of this
2 type of differential pricing could actually be achieved.

3 The basic concept related to the hypothetical
4 monopolist principle brings me to the focus of the
5 outline that I provided Greg for this session. As John
6 pointed out, I often use critical loss both before the
7 agencies and in testimony. And recently there have been
8 several questions raised about the use of critical loss.
9 Is it appropriate? Under what conditions is it
10 appropriate?

11 And to understand, let me just give brief
12 background on critical loss. In my mind, what critical
13 loss basically does is it makes the hypothetical
14 monopolist principle operational.

15 And all critical loss is is a two-step process
16 that first identifies for any given price increase the
17 sales that can be lost before the price increase becomes
18 unprofitable. So, in effect, it's setting a target. How
19 much sales have to be lost before it becomes
20 unprofitable?

21 The second step considers whether the actual
22 sales loss associated with the hypothesized price
23 increase will exceed the calculated critical loss. So
24 it's two distinct steps. And one might even argue it's a
25 third step, because this form of the critical loss looks

1 at a particular price increase. And in fact, the profit-
2 maximizing hypothetical monopolist can charge any number
3 of prices. So, a full application of critical loss would
4 look at a variety of prices and try to answer that
5 question.

6 Now, a practical consideration is -- as the
7 size of the price increase goes up, the confidence you
8 have in any answers you get seem to me to become less and
9 less. For example, you have greater confidence when
10 you're working with an observed interval of price
11 increases. Whether people deal with 5 percent increases
12 or 10, if you're talking about a 50 percent price
13 increase, you probably haven't observed changes like
14 that, and people's opinions are probably not as reliable.

15 Now, the answer to the first step, what is the
16 critical loss, how much can you afford to lose, that
17 ultimately depends on the size of the price increase
18 you're postulating, and the cost structure of the
19 hypothetical monopolist. In effect, the cost structure
20 tells you for every unit of sales you lose how much it
21 hurts.

22 The answer to the second step, how much will
23 actually be lost, can be ascertained by traditional
24 antitrust methods such as econometrics, other statistical
25 techniques, looking at business records, and going

1 through testimony. And this, in part, was what John had
2 talked about in the previous talk.

3 Now, one of the questions that has been raised
4 about critical loss concerns the relationship between
5 cost price margins and demand elasticity. There have
6 been three or four articles that raise this point. But
7 in particular, Michael Katz and Carl Shapiro have raised
8 the point that economic theory indicates that high
9 marginal cost margins tend to imply that actual loss
10 sales associated with the price increase will be small.

11 Well, the Carl Shapiro observation is based on
12 a theoretical inverse relationship between marginal cost
13 margins and demand elasticity that's encompassed in
14 what's called the Lerner index. And that, effectively,
15 is a residual of looking at profit maximization under
16 certain circumstances.

17 Now, there are several reasons why large gross
18 margins may be consistent with unit sales actually being
19 sensitive to price changes, and Katz and Shapiro identify
20 three of them. They note that firms in the market may
21 already be coordinating prices, and that will sever the
22 relationship. They also identify situations in which
23 there is a kink in the demand curve, and also situations
24 in which there is a kink in the supply curve.

25 I think there are a few other issues you have

1 to look at, and one of those, I think, is that the use of
2 the Lerner Index for this purpose fails to distinguish
3 between margins that are based on marginal cost --
4 meaning the margin of the last unit -- and those that are
5 based on the average variable cost of a significant
6 increment of quantity, where the answer may be quite
7 different.

8 The correct margins used in a critical loss
9 analysis should consider the actual average variable cost
10 associated with a significant loss of sales, often more
11 than 10 percent of current sales. And just to give an
12 example, one of the situations where I presented critical
13 loss was the Poplar Bluff Hospital merger case. It's FTC
14 v. Tenet.

15 And there, when we went back and we looked at
16 the costs, the question we asked -- and there is a little
17 bit of a chicken and egg thing there, and you have to be
18 careful -- but we knew from previous work that margins
19 for hospitals were somewhere in the range of 60 percent,
20 because there are a lot of fixed costs there, a lot of
21 fixed staffing.

22 So, what we did there was we got a hold of the
23 accounting system, we sat down, we worked with their
24 internal cost accounting system, and went through, item
25 by item, and asked the question in conjunction with

1 business people, "What would happen if you knew you were
2 to lose 10 percent of your sales for a year? Like, let's
3 say you lost a big managed care contract. What would
4 happen to the individual cost elements?"

5 So, in effect, asking what's variable over the
6 course of the year. And the answer we got was what we
7 used, and we ended up with margins there that were
8 similar to other hospitals. But lesson learned -- not a
9 surprise -- that if you took greater change in demand,
10 say 20 percent, or took a longer period of time, say two
11 years, then a lot of costs that are not variable under
12 the hypothetical that we presented become variable, and
13 the calculated margins change.

14 So, I guess the lesson from this is simply get
15 the right costs. Make sure that it fits the situation
16 and the questions being asked for the specific case.

17 Now, second point with regard to the Lerner
18 Index, going back there, is that the relationship that it
19 describes is limited in some sense. It applies to
20 monopolists and dominant firms, and it also applies to
21 industries where Bertrand-type competitors sell
22 differentiated products.

23 Now, and despite the fact that many, many years
24 ago I majored in math, I don't consider myself a
25 mathematician, so this is -- when I went back and looked

1 at Cournot models, you don't get the relationship in
2 Cournot models -- at least my understanding of that.

3 Now, it seems to me that if you're going to be
4 questioning things like critical loss, or anything else
5 based on particular models such as Bertrand-type models,
6 then the analysis in the case has to fit that model, and
7 has to incorporate all the implications of the specific
8 form of the Bertrand model -- in this case, that applies.

9 So, for example, Bertrand models tend to apply
10 best for differentiated products. But the relationship
11 that you have -- the relationship that Katz and Shapiro
12 talk about that comes from the Bertrand model doesn't
13 tell you a whole lot about closeness of substitutes.

14 Again, my understanding is that it doesn't tell
15 a whole lot about cross-elasticities. But when you're
16 analyzing differentiated products, a key issue is are
17 these close substitutes, and what happens, for example,
18 if you raise the price of one of them. The relationship
19 doesn't apply there.

20 And ultimately, this all brings us back to the
21 hypothetical monopolist principle -- I see my time is
22 running out. My overall view is that the application of
23 the guidelines is a major leap. Although there are
24 probably very specific circumstances where other
25 principles can apply, what it does is it focuses analysis

1 specifically on the questions that it's supposed to be
2 asking, and that is can market power be exercised.

3 Actually, I assume my time is up, so I'm just
4 going to just say thank you, and leave myself open to
5 Greg's questions.

6 MR. WERDEN: Thank you, Barry. I want to ask
7 you a couple of questions about your reaction to Katz and
8 Shapiro, and I want to start at an extremely basic level.

9 Their most basic point is that anybody who is
10 trying to make something out of high margins ought to
11 have some idea of what competitive process produced those
12 high margins, and be able to construct a comprehensive
13 argument that takes into account the competitive process
14 that produced those high margins. Do you agree with
15 that?

16 MR. HARRIS: I mean, it seems almost
17 tautological. Of course you want to understand the
18 process. The question, I think, is -- where we differ is
19 -- the last unit may be very small, but the question is
20 what does it look like over the range of the lost sales.
21 And that is basically a function of the cost structure in
22 the particular market is a market that has high fixed
23 costs. In the case of the hospitals, does it have high
24 minimum staffing that's not going to change?

25 Ultimately, any firm has to recover its costs,

1 or it goes out of business. And the high margins may
2 simply be reflecting high fixed costs.

3 MR. WERDEN: Well, unfortunately, Mike can't be
4 here today to say no, that isn't right, so I will say it
5 for him.

6 I think what Mike would say is, "Have you got
7 it backwards?" Prices aren't high because fixed costs
8 are high. If fixed costs are high, then some competitive
9 process will, in equilibrium, allow you to recover those
10 fixed costs, and that may mean that there isn't much
11 competition. Because if there was competition, you
12 wouldn't be able to recover those fixed costs.

13 So, whatever the facts are, there is a
14 competitive process out there that's producing those
15 margins. And what Mike and Carl say you need to do is to
16 examine that process and try to make sense out of it.

17 I think that you're disagreeing with them at
18 square one, and saying they're wrong about saying that
19 the competitive process had to be responsible for
20 creating the high margins. You're saying costs create
21 margins. Is that right?

22 MR. HARRIS: Well, that wasn't exactly what I
23 intended to say. I mean, I think competition ultimately
24 provides competitive prices equal to marginal costs.
25 Maybe included in that is going to be the return on some

1 costs, or people will not enter, and they're not going to
2 have as many competitors.

3 But I think part of the problem, too, is that
4 we're talking about a loss of sales here. So if you are
5 having some costs, you may have entered -- you may have,
6 at the margin, a very low margin -- by at the margin, I
7 mean the last units or so.

8 But if you have a large amount of fixed costs,
9 as you eliminate, let's say, 10 percent or 15 percent of
10 your sales, you may have a cost curve that has a slope on
11 it. And the difference between the price and the cost
12 curve can be substantial. It ultimately depends on what
13 the shape of that cost curve is. And you needn't have a
14 large margin for the very last unit, which is all the
15 Lerner-index relationship says.

16 MR. WERDEN: Okay. Let's change the topic only
17 very slightly. You point out that their analysis is
18 based on the Bertrand model, and obviously, that isn't
19 the right model for all industries. But there is no
20 doubt in my mind that it's the right model for some
21 industries.

22 And so, my question to you is, well, if it is
23 the right model and the margins are high, then doesn't
24 the analysis lead to their conclusion that the high
25 margins are consistent with very narrow markets, not

1 broad ones?

2 MR. HARRIS: I think it's going to depend --
3 and I'm not sure I completely understand the question --
4 but I think it's going to depend -- because in the
5 Bertrand model, you have differentiated products and you
6 may very well have different margins with the different
7 firms.

8 But that doesn't say anything is -- ultimately,
9 you know, you're getting to the merger, you're asking
10 what the cost elasticities are between different firms in
11 the market. That's important when you're dealing with
12 differentiated products, and I'm not sure --

13 MR. WERDEN: And they say it is.

14 MR. HARRIS: That --

15 MR. WERDEN: That the result is that if you're
16 in this Bertrand world with very high margins, then it
17 turns out that you need very little substitution, very
18 low cross elasticities among the firms in the industry in
19 order for the right conclusion to be that they form a
20 relevant market.

21 MR. HARRIS: Well, I mean, in the simple model,
22 for example, let's say you just have two firms and they
23 produce similar products but have different costs -- not
24 exactly the same products, but have different cost
25 structures. You're going to have one firm that has much

1 larger margins than the other. They compete, they're
2 close competitors, but if that firm with the better cost
3 structure is fully maximizing price, it's going to have
4 the large margins to move up to the cost structure of the
5 other firm. But if it raises it any further, it loses
6 sales. I mean, that's basically the Cellophane issue.

7 So, again, I'm not sure that I am understanding
8 your question, but I don't see that there is a conflict
9 there.

10 MR. WERDEN: Well, the question is: Aren't
11 they right in their case? In the Bertrand world, isn't
12 it true that high margins are almost always going to lead
13 to narrow markets because even if there isn't that much
14 competition among the firms in the market, there is
15 enough so that the market elasticity is enough lower than
16 the individual firm elasticities which, of course, have
17 to be low if the firms have high margins?

18 MR. HARRIS: I guess I just don't know the
19 answer.

20 MR. WERDEN: All right. Thank you, Barry.

21 MR. HARRIS: Okay, thank you.

22 MR. WERDEN: Our next speaker is Will Tom.

23 MR. TOM: Thank you, Greg. I'm not quite as
24 old as Barry, but I'm getting there. And I think back to
25 my first year as a young lawyer in the Antitrust Division

1 in 1979. And despite the fact that sophisticated
2 thinkers like Greg were already using the hypothetical
3 monopolist test, according to Greg at least since 1978, I
4 was there as a brand new lawyer, given my first merger
5 matter to look at, and I have to say I had a complete
6 sense of befuddlement about what to do, how to define a
7 market, and how to start thinking about this case.

8 And had I had more sense, I would have went up
9 a flight of stairs and asked Greg what to do, just as
10 Barry was able to get good guidance from George Hay. But
11 I didn't, and so I muddled along as best I could. From
12 that perspective, I think the 1982 merger guidelines was
13 really an advance. And if any ego-meters should be going
14 off the charts or breaking here, I think it should be the
15 ones in front of the people like Greg, who were actually
16 involved in that effort and in developing the guidelines
17 and propagating its use.

18 From that perspective, I think what I have to
19 offer are really just a handful of modest suggestions. I
20 think, on the whole, the guidelines are working well. I
21 think the guidelines approach is a good one, and
22 notwithstanding the quote from George Stiegler that John
23 mentioned, it really is operational, by and large.

24 And my handful of modest suggestions come under
25 two headings. Heading one, we ought to have a more

1 explicit recognition of the role of uncertainty as we
2 apply these guidelines. And heading two, I think, is
3 that we ought always to bear in mind that the underlying
4 purpose of market definition is the assessment of
5 competitive effect. I think that's a truism, but I will
6 try to put a little bit of flesh on it as I go along.

7 Under the role of uncertainty, I guess my first
8 suggestion is that the staff be aware of the tendency of
9 the iterative hypothetical monopolist test to
10 unconsciously reverse the burden of proof.

11 Now, I know that the guidelines explicitly say
12 this is not intended to say anything about burden of
13 proof, burden of persuasion, where that lies, or anything
14 else. But there is a natural human tendency to put the
15 burden of proof on those who are asserting that something
16 inherently uncertain will occur, as opposed to those who
17 say that something inherently uncertain will not occur.

18 And if you think about how the iterative
19 hypothetical monopolist test works, you start by positing
20 a 5 percent -- or, you know, some other significant non-
21 transitory price increase. So, the price increase is
22 taken as a given, that's a fact. Now you ask, well, what
23 would happen in response to that price increase by a
24 hypothetical monopolist if that price increase were to
25 take effect? Would competition come into this tentative

1 market to defeat that price increase? Right?

2 And so, you know, the real answer in many cases
3 is, well, who the hell knows? Right? But since that
4 really is a non-operational approach to the practical
5 question of getting through the analysis of a particular
6 merger, you know, the next step is to say, well, what do
7 we think is going to happen?

8 And it is a very small step to slide from there
9 to saying, well, parties, you know, prove to us that the
10 price increase by this hypothetical monopolist will, in
11 fact, be defeated, right? And you go through enough
12 iterations, you know, prove that the price increase would
13 be defeated, and you end up with, you know, a very high
14 threshold, I think, of establishing that the market is as
15 broad as maybe it really is.

16 And so, there may be a certain inherent bias in
17 favor of markets that are too narrow. And now, I can't
18 prove it, it's just an intuition, but I think that that
19 may be just a natural consequence of the way we approach
20 questions that are inherently uncertain.

21 My second point about uncertainty is in a
22 similar vein. And it's not really a market definition
23 question as such, it's a question of, you know, the next
24 step after market definition, and the next step after
25 that, and how it relates to the process of market

1 definition.

2 And I am reminded of a scene in the play or
3 movie, "Amadeus," where the Emperor Joseph says of a
4 Mozart opera, "Well, the only problem here is too many
5 notes." And there may be a sense in which the effect of
6 the many steps in the merger guidelines process is to
7 lead to some errors in situations of an inherent
8 uncertainty.

9 And to take a very stylized example, imagine a
10 merger investigation in which the analyst concludes that
11 there is a 51 percent probability that the merging
12 parties A and B are actually in the same market
13 themselves, right? I mean, the -- you start with a
14 product of one of the merging parties, and you ask in the
15 event of a SSNIP what would happen, and would the product
16 of B come in to thwart a price increase by A. And then
17 you go from there.

18 Okay. Let's suppose that there is a serious
19 question about that first step, and maybe the merging
20 parties aren't even in the same market. But you conclude
21 with 51 percent probability, they probably are in the
22 same market.

23 All right. Next step you have got another
24 player, C. He might be an uncommitted entrant, right?
25 He might be able to start selling this product, even

1 though he is not currently selling the product without
2 substantial cost in a very rapid period of time.

3 Well, let's suppose you can reject that
4 proposition, again, by a 51 to 49 percent margin, right?
5 There is only a 49 percent likelihood that uncommitted
6 entrant would come in. And so you say C is not a
7 participant in the market.

8 And let's suppose there is another potential
9 entry, D. And maybe he's not currently producing a
10 related product, so he would have to expend some costs.
11 And so, after careful analysis, you conclude that, well,
12 there is only a 49 percent likelihood of committed entry.
13 And therefore, more likely than not, D will not enter the
14 market.

15 Okay. Well, how do you analyze this merger as
16 a whole? If the question is: Is this merger likely to
17 be anti-competitive, and assuming a lot of those
18 probabilities are independent, you ought to say, "Okay,
19 well, what's 51 percent times 51 percent times 51
20 percent," and you come out with about a 13 percent
21 likelihood that this merger is going to do any harm,
22 right?

23 I think there is a tendency for at least
24 beginning analysts to say, well, more likely than not A
25 and B are in the same market, okay? Now, is there going

1 to be uncommitted entry? What are the participants in
2 the market?

3 Well, more likely than not, there is not going
4 to be uncommitted entry, so we will reject the argument
5 that the parties are advancing about uncommitted entry.
6 Now, you know, is there going to be entry as the
7 guidelines define it? Well, more likely than not there
8 is not going to be entry, right? So you have got, you
9 know, two merging parties in the same market. Nobody
10 else in that market, no entry likely to come in.
11 Therefore, we should challenge the merger.

12 It is, I think, really difficult for the
13 merging parties counsel to know when the staff is
14 thinking this way. You have a somewhat asymmetric
15 process whereby the staff is properly reticent about
16 sharing information that they are learning from third
17 parties, and that can sometimes inhibit the dialogue.
18 And if they are thinking this way, it's sometimes hard
19 for the parties even to know it, let alone talk them out
20 of it.

21 So, I throw that out as something for the
22 agencies to at least be cautious about in their internal
23 deliberations.

24 Third uncertainty point, if you want to call it
25 that, is the whole issue of customers say they wouldn't

1 switch. And we're talking about that at some length this
2 morning about affidavits and survey evidence, and so on
3 -- particularly in intermediate goods industries, where
4 the staff is relying on customer telephonic interviews in
5 ways that they probably are not in consumer goods.

6 Again, it can be hard to tell what's actually
7 going on there behind the curtain. I think John pointed
8 out that when you're doing survey evidence, your survey
9 experts will take quite a lot of pains to work with you
10 to get the biases out of the questions and to, you know,
11 avoid some of the more obvious errors about how the
12 questions are phrased, and the sample of respondents
13 they're posed to, and so on.

14 Where you're relying on the telephonic
15 interviews with customers, the danger of badly worded
16 questions eliciting misleading information about the
17 inherently unknowable is probably at its highest. And it
18 is also the situation in which fruitful dialogue between
19 the party's counsel and the staff is at its most
20 difficult because of concerns about third-party
21 confidentiality.

22 And it is very easy to slip into highly
23 unproductive dialogues that start and mostly end with
24 staff saying, "Well, customers say they wouldn't switch."
25 And I know Greg has been preaching this for a very long

1 time, and I think, by and large, the agencies are doing
2 this: The dialogue is much more productive if you ignore
3 what the customers say they would do and focus all of
4 your attention on the reasons that they give for what
5 they say what they would do, and really dig into the
6 objective facts that make switching more or less likely,
7 because that is something that the parties generally can
8 engage on.

9 And it is a lot more concrete and reliable, I
10 think, than the speculation about what, you know, what
11 third parties -- what customers say they would do under
12 circumstances that they may not really have faced and
13 really may not have thought through.

14 All right. Well, let me turn to the other
15 major heading, which is that assessment of competitive
16 effect is the underlying purpose of market definition.

17 And I guess the first question I want to
18 address is when should we depart from five percent? You
19 know, the guidelines say that in appropriate
20 circumstances, we can use numbers other than five percent
21 as your SSNIP, but they don't say what those appropriate
22 circumstances are.

23 And let me take you through an example that's
24 already covered by the guidelines, because I think it's
25 easier to understand and then go from there to situations

1 I think that aren't really covered by the guidelines.

2 Well, let's suppose you have got a market in
3 which a five percent price increase is unprofitable, but
4 a 10 percent price increase is profitable. I mean, why
5 would that happen? Well, in response to a five percent
6 price increase, you lose a certain block of customers.
7 You don't make enough on the customers that you keep to
8 make up for the loss of revenues from the customers you
9 would lose. And therefore, the five percent price
10 increase is unprofitable.

11 The next tranche of customers you would lose is
12 highly price-inelastic, though. So if you raised the
13 price by 10 percent instead of 5 percent, you don't lose
14 very many more customers, but you make a lot more on the
15 customers that you do keep. And I gather Greg, in some
16 of his writings, has dealt with this situation, and maybe
17 others have, as well.

18 In that situation, if the guidelines simply
19 said, you know, look at a SSNIP and see what would
20 happen, then you would say, "Well that would be a good
21 case for upward departure on the five percent, because
22 after all, the purpose of the guidelines is to detect the
23 likelihood of competitive effect, I'm simplifying past
24 the coordinated effects step, and assume perfect
25 coordination, or assume only two players or something --

1 it wouldn't make any sense to have a set of guidelines
2 that protected against a 5 percent price increase but
3 didn't protect against a 10 percent price increase.

4 As Greg has pointed out, the guidelines say "at
5 least." So, if a hypothetical monopolist could maintain
6 a price increase of 10 percent, then the SSNIP test is
7 satisfied, even under the hypothetical that I am talking
8 about.

9 So, the case for an upward departure would have
10 to involve somewhat more exotic examples. Imagine that A
11 and C are merging. B is a closer competitor than C. A
12 hypothetical monopoly of A and B could not sustain a 5
13 percent price increase for the same reasons I described,
14 but could do so with a 10 percent price increase.

15 And you know, should you call this a market and
16 examine the competitive effects of a merger of A and C,
17 or should we say that C is outside the market all
18 together, and kind of stop your investigation there.
19 There are scenarios in which it would make sense to keep
20 going.

21 The downward departure scenario is more
22 straightforward. Five percent price increase is not
23 sustainable, but a one percent price increase would be,
24 because relatively few customers are diverted. It's
25 going to be the inverse of the example that I started

1 with.

2 And there, I think the theoretical case is
3 there for a downward departure I guess I have qualms --
4 hearkening back to the theme of uncertainty in the last
5 group of examples I talked about. If, by hypothesis, a
6 price increase of five percent or more couldn't happen,
7 even with perfect coordination among all marketplace
8 participants, that puts an upper bound on how much damage
9 can be done if you fail to challenge the merger.

10 Given the vagaries and the uncertainties of
11 life, maybe that should be enough. I have suggested
12 somewhat facetiously that maybe we should delete the part
13 of the guidelines that says this five percent is not a
14 tolerance level. And yet there ought to be some
15 tolerance level in the merger guidelines.

16 And I am not sure what the right tolerance
17 level is, but it should be one that recognizes that, you
18 know, the whole process of merger analysis is an inexact
19 science, at best. And if you're reasonably confident
20 that there is a fairly low upward bound on any damage,
21 maybe you ought to stop there and let this merger go
22 through.

23 All right. I am running short of time, so let
24 me hasten quickly through my last two points. Just for
25 aesthetic reasons maybe, if nothing else, can we do

1 something to reconcile the unilateral effects discussion
2 of competitive effects with the market definition
3 process?

4 And here, in particular, I focused on the
5 sentence in Section 1.11 of the guidelines that reads --
6 and I quote -- "In performing successive iterations of
7 the price increase test, the hypothetical monopolists
8 would be assumed to pursue maximum profits in deciding
9 whether to raise the prices of any or all of the
10 additional products under its control."

11 And I am not entirely sure what that means, but
12 I think what that means is that if you can show the
13 sustainability of a five percent price increase in only
14 one of the hypothetical monopolist products, that's
15 sufficient to define a market.

16 You know, if that's right, then why do you need
17 analysis? This aspect of market definition that says you
18 define a market based on the hypothetical monopolist
19 raising price on one product, you know, doesn't that mean
20 that any decent unilateral effects case is a merger to
21 monopoly?

22 And I guess, you know, the bottom line on this
23 one is I'm just confused. I'm not sure that this anomaly
24 has actually done any harm to merger analysis, but it
25 certainly has made it a whole lot more confusing and

1 maybe has made the guidelines just a little bit less
2 transparent to pick up one of the themes raised by our
3 keynote speakers.

4 And given the amount of time, I am going to
5 drop my last supply substitute ability point, which Greg
6 tells me fits better in another session, anyway, and open
7 myself up to the cross examination.

8 MR. WERDEN: Okay. Thanks very much, Will. I
9 want to explore some of these suggestions you made, and I
10 want to start with the issue of the upward departure. It
11 might not be an accurate characterization, but we will
12 use that as a shorthand.

13 And the case -- I think the only case -- that
14 really focused on this issue is the Olin case in the 9th
15 circuit where, in order to sustain the FTC's decision
16 that the merger was unlawful, the 9th circuit had to be
17 persuaded that a 5 percent price increase ought not to be
18 looked at, but rather a 10 or more percent increase
19 needed to be looked at. And it maybe needed to be more
20 than 10.

21 And the FTC did persuade the 9th circuit of
22 this, and I think this illustrates what I think you had
23 in mind by an upward departure. And what I want your
24 comment on is whether you think the FTC and the 9th
25 circuit had it right.

1 MR. TOM: All right. I am not going to comment
2 on the specific case, only because I haven't studied it
3 recently. And giving the advancing age I alluded to at
4 the beginning, one of the first things that goes is
5 memory.

6 MR. WERDEN: Well, neither of us actually knows
7 the facts of the case, so that's not really what my
8 question is. My question is: Is the idea if for a 15
9 percent price increase these two swimming pool sanitizer
10 chemicals would be in the same market, should you just
11 say, "Well, okay, put them in the same market?"

12 MR. TOM: Yes, I think it depends. If there is
13 a credible theory of competitive effect that says, in
14 effect, that, unless we do something there will likely be
15 an anti-competitive effect -- I wonder whether we ought
16 to let market definitions stand in the way.

17 And I alluded to the hypothetical situation in
18 which you have got three players, and they really aren't
19 -- back up a second, because I didn't go into this
20 hypothetical too deeply.

21 I posited three players, because you can
22 imagine a two-player market in which a five percent price
23 increase would not bring one of the party's closest
24 competitor into the market. I mean, yes, let's start
25 with not a hypothetical monopoly, but an actual monopoly.

1 Even a five percent price increase will not bring the
2 closest competitor in.

3 And you say, should you, let A merge with B,
4 its closest competitor? And I think most of us would say
5 intuitively, no. It wouldn't make any sense to allow
6 what would be a fairly dramatic competitive effect under
7 that circumstance.

8 Well, one might cavil about whether that
9 hypothetical is realistic in the first place, because if
10 a five percent price increase by the monopolist wouldn't
11 bring closest competitors in the market, then why isn't
12 the monopolist pricing it at that level already?

13 And so, I posited another competitor, B, that
14 is closer than competitor C that A is acquiring. So the
15 current price is constrained by B. And that's why prices
16 haven't gone up already.

17 Now, the question is can the acquisition still
18 make a difference? I think there are certainly models in
19 which the acquisition of the next closest competitor does
20 make the difference.

21 In such a circumstance, does it make sense to
22 say, "We should treat C as not being in the market in the
23 first place so why worry?" I think not. I think you
24 probably want to look at that model a little more closely
25 and see this competitive effect really realistic? Is it

1 likely to happen? Are you convinced as a factual matter?

2 MR. WERDEN: One last question relating to your
3 comment on tolerance level. I think it is important, as
4 you suggest, to recognize uncertainty in our forecasts.
5 But I want to try to flesh out exactly what you're saying
6 here.

7 Let's suppose we had a unilateral effects case
8 in which the government believed that the result of a
9 merger would be one merging firm would increase price
10 eight percent, and then the other one would increase
11 price four percent, for a market-wide average price
12 increase of three percent, or make it two percent.

13 The three and the two percent are below the
14 magic five. In fact, even the four percent for one of
15 the merging firms is below the magic five. Assuming that
16 there isn't a tremendous amount of certainty, so that we
17 really don't know anything, do you really believe that
18 the agencies should say, "Well, eight percent, four
19 percent, forget it. It's not that much."

20 MR. TOM: The assumption was there is not a
21 tremendous amount of uncertainty, or --

22 MR. WERDEN: Well, not so much that we really
23 don't know anything. There is always significant
24 uncertainty.

25 MR. TOM: Yes. No, I'm not proposing selecting

1 a magic number of five percent, or whatever, as a
2 tolerance level. Yes, I do think that, in circumstances
3 where we can be pretty confident about the upper bound of
4 harm, and we can't be at all confident -- or we can be
5 somewhat confident, but only barely so -- that there is
6 any harm at all, I think we ought to very seriously
7 consider letting that one through.

8 MR. WERDEN: And not a question, but just a
9 comment. The sentence of the guidelines that you quoted,
10 in fact, does not mean what you supposed, but the
11 following sentence does.

12 (Laughter.)

13 MR. TOM: Okay. I stand corrected. Thank you.

14 MR. BLUMENTHAL: Good morning, everybody. I am
15 Bill Blumenthal, and as the clean-up hitter, I suppose
16 I'm going to reshape my comments a little bit to address
17 some of the things that were said by the three earlier
18 batters.

19 We begin by noting that there is not a whole
20 lot of disagreement among the speakers, at least so far,
21 save for two things that my former partner and good
22 friend, Will Tom, said in passing.

23 The first was simply the reference to too many
24 notes. And my recollection is that that was not Emperor
25 Joseph criticizing Mozart, but Mozart criticizing

1 Salieri. And I'm pretty sure Tim Hulce was the one who
2 said it, but we're going to have to go back and check the
3 tape. I'm not going to dwell on that point.

4 The second thing where I think we had a little
5 bit of disagreement -- and again, it was sort of a throw-
6 away line by Will -- was the observation that, all in
7 all, the guidelines are working well. I'm going to spend
8 more time on that one because, to me, I mean, the
9 guidelines are working well, I suppose, but only because
10 most of the people who are using them know what the code
11 words mean, and are largely ignoring them as the recipe
12 for which they were originally intended.

13 And that's really the point where I am going to
14 devote most of my remarks, but let me first begin with a
15 little bit more on the areas of agreement -- or I think
16 agreement -- among us all.

17 The hypothetical monopolist test has basically
18 won. I mean, I think pretty much all analysts adopt it,
19 most of the commentators adopt it. It is not universally
20 adopted in the courts, but it has largely prevailed in
21 the courts. We generally know which tools work. We had
22 some tools as early as 1983 or 1984. Those, obviously,
23 have been amended substantially.

24 We had a pretty good set of information about
25 which tools do not work. I agree completely with John

1 Harkrider and Will Tom, that affidavit battles are not an
2 especially productive or illuminating form of arms race.

3 I agree with Will on the issues of burden of
4 proof, and biased narrow markets, although whether it's
5 too narrow is sort of a judgment call we can talk about.
6 But unilateral effects, I agree with Will about his
7 supply-side point that he didn't make here, but you will
8 have to read the paper.

9 And basically, I think pretty much all of us
10 would say that if market definition is to remain a
11 discreet early step in merger analysis, that the
12 hypothetical monopolist test is the right test.

13 Now, to the disagreement, let me be a little
14 bit incendiary at least, and pose to you the question of
15 whether, in fact, we ought to be retaining market
16 definition as a discreet, early step in the analytical
17 process as it is used nominally, under the guidelines.

18 For at least five years now -- and just
19 watching the way we work, watching the way the agencies
20 work -- I have been posing to people the question of
21 whether market definition is an input into the
22 competitive analysis, or whether it isn't really an
23 output. And I think that Greg has largely convinced me
24 that it's neither, it's really an issue of simultaneous
25 determination.

1 But the one thing that I think is fairly clear
2 -- at least the way that most of us go about our business
3 day to day -- is that it is not a pre-standing form of
4 analysis done by reference to a hypothetical monopolist
5 test, where you then plug that answer into the stuff that
6 follows.

7 On the defense side, in the U.S. I have not
8 defined a market in at least 10 years -- I think it's
9 probably 15. I mean, we defined it on the plaintiff's
10 side, because that's one of the things you have to do if
11 you don't want to have your complaint thrown out of
12 court. We define it sometimes in some European
13 jurisdictions, because that's one of the things you have
14 to do there if you don't want to have your filing thrown
15 out of the agency.

16 But as an analytical tool in the U.S., we don't
17 use it. My sense is that, by and large, the agencies
18 don't do it. I mean, what the agencies, I think,
19 typically mean by market is that grouping where, at the
20 end of the analysis, a product -- the problem -- is
21 found. And from my perspective, that is a perfectly
22 sound way to go about the analysis.

23 You know, I noted that Jon Baker and Dale
24 Collins are both on the final panel on the third day.
25 And I note that here, in particular, because I was not

1 aware of that fact when I cited both of them in the paper
2 that I guess has not yet been released or put out front,
3 but will be. I'm sure sooner or later, the papers will
4 emerge from this conference.

5 I cited to Jon for purposes of his paper on
6 "res ipsa loquitur" market definition, and "res ipsa
7 loquitur" merger analysis. And we, of course, in the
8 private side all beat on Jon for being lawless -- for
9 reasons I will get into in a minute -- because it is
10 fundamentally lawless. But it's actually a pretty sound
11 way of thinking about the issue.

12 And I cited to Dale for a three-step analysis
13 that I first saw him use about 12 years ago, and that I
14 and a lot of others have picked up. I mean, rather than
15 going through the guidelines type of test, what we
16 usually do when we sit down with clients is pose three
17 short-form questions: Where is the value of the deal;
18 what are the customers going to say; what is going to
19 happen to price?

20 And for this purpose, I am using price as a
21 surrogate for all of the other competitive variables that
22 you might get into. And when you poke and probe, you
23 might get into innovation, into quantity, into just all
24 of the things you might worry about.

25 The first two of those are really background

1 information. I mean, where is the value in the deal?
2 You want to hear whether it's on the price increase side
3 or the cost decrease side. We take it as a given that
4 the assets are going to be more profitable in the hands
5 of the buyer than in the hands of the seller. Otherwise,
6 presumably, a deal wouldn't happen. Presumably, there is
7 some margin increase somewhere, and the question is
8 what's the source of the margin increase.

9 And in terms of what customers are going to
10 say, that's partly just to find out what's going to
11 happen if we do get into an affidavit battle, and it's
12 also to poke and probe a little bit about, well, why are
13 the customers going to say that? Why do they care? Why
14 don't they care?

15 And it's really that third question, the what's
16 going to happen to price, what's going to happen to other
17 competitive variables. We want to hear the answer. And
18 as often as not, you will pose the question 15 different
19 ways. One of the ways I'm fondest of posing it is,
20 "Well, in which of your products are you most likely to
21 have a price increase that sticks?" And sometimes they
22 will say, "Well, it's this grouping right over here," and
23 then you poke and probe on that.

24 But I would suggest to you that if you really
25 want to handle the merger efficiently -- if we all want

1 to handle mergers efficiently -- and I pause a little bit
2 before saying this, but I think we will say it anyway, we
3 have a lot to learn from the doctors.

4 I mean, when you go in and you have a problem,
5 typically what the doctor does is take a bit of the
6 history and formulate some hypotheses, and then you flip
7 into a mode of rule out a problem. And the way the
8 medical profession does it is they run a bunch of tests
9 sequentially to rule out this problem, rule out that
10 problem. And at the end of the process, if you have
11 tests that are consistent with the problem, then you
12 treat the problem.

13 And if at the end of the process you don't have
14 a problem, and you can't come up with any other
15 hypotheses, well, then you move on.

16 Now, the issue we all have is how do you
17 translate this into legal doctrine in a system where you
18 have case law that has very, very strong authority on two
19 propositions?

20 First, you have to define a market. And
21 second, the market definition is step one of the
22 analysis. And I muse a little bit about that in the
23 paper that will eventually be forthcoming. I mean, there
24 are several approaches, none terribly satisfactory, that
25 one might come up with to try to reconcile case law with

1 the mode of analysis that's actually practiced.

2 And it seems to me that if we were going to try
3 to take the next set of steps and conform guidelines to
4 practice as we know it, that is the fundamental problem.
5 I mean, how do we skin the cat of not getting thrown out
6 of court? Well, actually, it's not my problem, it's the
7 Agency's problem, but how would the Agency skin the cat
8 of not getting thrown out of court?

9 But let me leave you with this thought. I'm
10 going to close with this. First, it does seem to me --
11 and this is where, again, I join up with Will, or maybe
12 against Will, in saying the guidelines are working well.
13 It does seem to me that the guidelines are affirmatively
14 misleading as a recipe for how analysis is actually
15 conducted, you know, 12 years after their most recent
16 revision.

17 Second, the business community is fundamentally
18 confused about how you do the analysis. I mean, it's
19 pretty common that we will sit down with a client for the
20 first time and the client will have worked through the
21 guidelines. And you can't believe how far off the
22 analysis is.

23 Now, the 68 guidelines went 14 years before
24 they were revised, and we're obviously not at 14 years
25 yet. And I would not lightly call for the Agencies to

1 undertake a process of revising the guidelines, because I
2 know how complex that is and how burdensome that can be.
3 So I'm not going to say that.

4 But I will say that the time probably should
5 come one of these years -- almost certainly not before
6 the election, but maybe 2005, 2006 -- it probably would
7 be productive for people to sort of sit back and say,
8 "What do we mean by market, and how, really, are we going
9 to try to operationalize what we're doing, if what we're
10 going to seek in the way of guidelines is a pretty
11 transparent set of recipes that depict the enforcement
12 practices to the public?"

13 And with that, any questions, Mr. Moderator?

14 MR. WERDEN: I have a few. First, I'm actually
15 quite confused about what you mean when you say that the
16 guidelines are misleading on how the analysis is
17 conducted. I'm not sure that they tell anybody how the
18 analysis is supposed to be conducted, so I don't know how
19 they could be misleading. What is it, exactly, that you
20 have in mind?

21 MR. BLUMENTHAL: Well, I guess I'm using
22 misleading in the FTC Bureau of Consumer Protection
23 sense.

24 (Laughter.)

25 MR. BLUMENTHAL: Which basically means that you

1 have a population of readers that are interpreting the
2 words in a way that is not entirely consistent with what
3 the words literally are intended to convey, that you have
4 -- and by the way, I mean, it's not just the public. It
5 seems to me that the same thing applies to certainly
6 agency staffers overseas who try to apply our guidelines,
7 and I think I would go on to say some agency staffers
8 within our borders who try to apply our guidelines.

9 The iterative aspect of the analysis is
10 something that is often fundamentally missed. The fact
11 that market shares are not what you see in the documents,
12 but rather what you calculate after going through all of
13 the rest of the steps preceding competitive analysis,
14 that's something that is quite commonly missed.

15 You know, Will's point on unilateral effects, I
16 think, is pretty fundamental. So that's what I mean by
17 misleading, that people -- large numbers of people -- are
18 simply misconstruing how you're supposed to do the
19 analysis. And in particular, where market definition
20 comes in.

21 MR. WERDEN: Well, in that regard, let me
22 suggest that the guidelines disclaim being a step-by-step
23 instruction manual, and perhaps best should be described
24 as an outline for how one ought to present the results of
25 the competitive analysis of a merger.

1 And if viewed in that light, is there anything
2 misleading about the guidelines? Is there anything
3 problematic about the way they choose to organize these
4 issues in a manner, as you commented in some of your
5 articles 20 years ago, fairly consistent with the case
6 law that constrains how the government can litigate its
7 cases?

8 MR. BLUMENTHAL: Yes. I think with that
9 qualification, the guidelines remain reasonably accurate.
10 I'm not sure about a separate 35 percent test for
11 unilateral effects -- which I think is still in there --
12 well, depends on how you define the market, I suppose,
13 which is sort of the point.

14 But I'm not sure that that component is
15 something that withstands challenge. But that's a really
16 minor quibble. And yes, subject to the observation that
17 the disclaimer says they are not a recipe, and that the
18 public -- if you're going to say the public shouldn't use
19 them as a recipe, then they hold up pretty well. The
20 problem, of course, is people do use them as a recipe
21 because they don't have any other recipes.

22 MR. WERDEN: Okay. Thanks very much, Bill. I
23 have a large number of prepared questions. But before I
24 launch into them, I want to offer the panelists an
25 opportunity to respond to what else they have heard thus

1 far.

2 MR. HARRIS: I actually have a question of you.
3 I think it was you asking questions about when there were
4 switching costs and issues with exploiting the installed
5 base, and at least it wasn't clear to me exactly what you
6 were asking, so I ask that you kind of elaborate on it
7 and explain better the situation that you have in mind
8 where a merger might harm competition.

9 MR. WERDEN: Well, sure. I had in mind a very
10 simple-minded situation in which every current user is
11 locked in to his supplier, for whatever reason. Don't
12 ask me to explain, I think it will be hard to explain
13 that. But suppose it is so.

14 The hypothetical monopolist could exploit these
15 guys, because they're locked in. And then the issue
16 would be, well, what about new customers? That's usually
17 where the competition is, of course, to attract the new
18 customers and to sign them up and to get them locked in.
19 And a hypothetical monopolist might be able to
20 discriminate between the two, and might not.

21 And one would have a somewhat different
22 analysis of the merger, depending on which of those
23 circumstances you thought you were in. But one clear
24 possibility is that you can't discriminate, so all a
25 hypothetical monopolist could do is exploit the guys who

1 are already locked in.

2 And my question is, well okay, in that event is
3 there any way that you would specially account for
4 switching costs in the application of the 5 to 10 percent
5 price increase test, and my answer would be no. You
6 don't do anything different or special in that case, not
7 in delineating the market.

8 MR. HARRIS: But you would not ignore it in
9 looking at competitive effects, is that accurate?

10 MR. WERDEN: You would not ignore anything in
11 looking at competitive effects.

12 MR. HARRIS: I understand.

13 MR. WERDEN: But part of what the guidelines
14 are trying to tell you is what category various issues
15 fall into. And the guidelines say, "Well, some issues
16 are market delineation and some aren't." And a whole lot
17 of them aren't.

18 MR. HARRIS: Okay. And then I guess the
19 follow-up question I have in the context of a merger, if
20 these customers are locked in, is your suggestion that
21 there is a way in which the merger can make that
22 situation worse? And if so, what is that?

23 MR. WERDEN: Oh, that's an excellent question.
24 It isn't necessarily so that the merger can make the
25 situation worse, and that's where the competitive effects

1 analysis ought to be. It may very well be that when you
2 get to the competitive effects analysis you conclude that
3 the locked-in customers are exploited as much as locked-
4 in customers can be exploited, and the merger doesn't
5 affect that, and the focus ought to be on the new
6 customers, because that's where all the competitive
7 action is. I have certainly seen mergers where that was
8 my view.

9 But you can imagine, certainly, that the
10 switching costs between incumbent suppliers are much
11 smaller than the switching costs between an incumbent
12 supplier and somebody outside the candidate market, in
13 which case it may very well be that there is some effect
14 on the degree of exploitation of the locked-in customers,
15 because they're not completely locked in.

16 Anybody else have any comments or questions?
17 No? Okay. The hypothetical monopolist test has come in
18 for almost entirely praise from our panelists today. And
19 my question is has it completely won the intellectual and
20 legal battle -- and those are two different battles --
21 and I think the answers may be different.

22 Put another way, is there an alternative that
23 makes any sense to use? And I think this question has to
24 be posed in two different ways. One, an economic/policy
25 perspective, and the second one, a legal one. And with

1 respect to the economic perspective, I pose the question
2 to Barry. Does economics offer any alternative?

3 MR. HARRIS: Well, the first thing would be my
4 disclaimer, "Never say never." But I'm hard pressed,
5 with a few exceptions, to think of something that
6 performs better, and it gets back to what question are
7 you asking: What is the group of competitors, that if
8 they were able to coordinate, could exercise market
9 power?

10 Now, it seems to me -- alternatives that -- at
11 least the ones I have seen -- are inappropriate. Maybe I
12 haven't seen them all. Or, alternatively, they default
13 to the same question asked in a different way.

14 And just as an example, I think it was John, in
15 his talk, he mentioned successful price fixes, and he
16 also mentioned the Staples case. Well, I think it is
17 fair that if you can look at real-world information, it
18 may tell you what the market is. But what is a
19 successful price fix? At the end of the day, assuming
20 all the conditions are reasonably similar, what you have
21 done is you have done the hypothetical monopolist test,
22 you have just run it out in the real world.

23 Same in Staples. My understanding of that case
24 -- which is imperfect; I didn't work on it -- but despite
25 all the talk about econometrics, at the end of the day,

1 if you read the decision, you will see the judge kind of
2 ignored everybody's econometrics. But my understanding,
3 an important fact of that case was that the two companies
4 each had pricing zones that were defined by the existence
5 of the other company, and these were the low price
6 pricing zones.

7 Well, again, you can say that's real-world
8 information, and it's a different way of going about it.
9 But at the end of the day, it's telling you an answer to
10 the hypothetical monopolist question. So there may be
11 different paradigms, but I'm not aware of them. And the
12 ones I am aware of seem to me to be just a round-about
13 way of getting to the same point.

14 MR. WERDEN: Okay. Thanks, Barry. Bill, I
15 will ask the legal side of the question to you. In your
16 remarks -- I paraphrase -- you said -- I didn't get the
17 exact remarks -- you said the hypothetical monopolist
18 test has "won." But yet we still read district court
19 opinions that cite the Brown Shoe practical indicia.

20 Is it your view that the courts are really
21 relying on the practical indicia, or are they ultimately
22 really relying on the hypothetical monopolist test, or
23 some interesting combination of the two?

24 MR. BLUMENTHAL: Well, when I say "won," I mean
25 primarily in the hearts and minds of commentators,

1 analysts, and the antitrust cognoscenti.

2 With respect to the courts, I think,
3 increasingly, the test is the decisive test. But there
4 still are some courts that are laggards. I think the
5 question, in large part, turns on how economically
6 sophisticated the judge is. I think it turns, in large
7 part, on how facile the judge is on reconciling the legal
8 standard which perhaps she believes makes sense with what
9 she thinks she has to put down to avoid getting reversed
10 by the court above.

11 So, as an evidentiary matter, the courts
12 continue to rely pretty heavily on Brown Shoe. And the
13 practical indicia, of course, are a submarket test. But
14 as Brown Shoe says, a submarket can, itself, be a market.
15 So it all gets completely commingled.

16 And I think that for a long time to come we
17 will continue to see courts citing to the tests that have
18 been articulated by other courts, it's just that we're
19 beginning to see more and more courts speaking favorably
20 about the guidelines, about the hypothetical monopolist
21 test, and that then creates a body of precedent where,
22 sooner or later, courts will be able to rely just on that
23 without necessarily linking it back.

24 MR. WERDEN: Let's get a little more specific,
25 and talk about the Staples case. There is, you know, at

1 least three or four pages in the Staples case relating to
2 the practical indicia.

3 MR. BLUMENTHAL: Yes.

4 MR. WERDEN: Is there doubt in anybody's mind
5 here that the only fact -- and it may be more than one
6 fact, but I will call it "a fact" -- that ultimately
7 persuaded the reasonably skeptical judge about this
8 funny-looking market was that there was very clear
9 pricing evidence that the number of office superstores
10 really was affecting prices?

11 MR. HARKRIDER: Greg, if I can make a point?

12 MR. WERDEN: Sure.

13 MR. HARKRIDER: I think that Staples actually
14 provides an illustration of the relationship between
15 Brown Shoe and the hypothetical monopolist test. I think
16 that the hypothetical monopolist test is frequently used
17 as an economic test as opposed to Brown Shoe, where there
18 is quantitative evidence of the sort, or very clear
19 evidence of the sort that directly bears on the
20 hypothetical monopolist test.

21 I think where there is very little evidence as
22 to whether a hypothetical monopolist could, in fact,
23 impose a SSNIP -- which -- and by that I mean there is no
24 econometric evidence, there is no natural experiment,
25 there are no surveys, there are no affidavit evidence --

1 I think in that context they frequently rely upon Brown
2 Shoe. And if the quantitative evidence is relatively
3 weak or not determinative, then they rely upon Brown
4 Shoe.

5 I think Staples is a case where you have
6 essentially, a natural experiment that allowed you to get
7 direct evidence and get some purchase on the hypothetical
8 monopolist test. And so, Brown Shoe wasn't particularly
9 instructive.

10 MR. WERDEN: Okay. Well, let's try a different
11 case. Let's try Swedish Match. There was quantitative
12 evidence in the case, but the court was totally
13 unpersuaded by it on both sides. And the court cited
14 Brown Shoe factors.

15 But the way I read the decision, ultimately the
16 judge sat back and looked at the totality of the evidence
17 and said, "Well, if I think of a hypothetical monopolist
18 raised the price five percent, he would make more money."
19 So it's a market.

20 MR. HARKRIDER: I think that that's right, but
21 I think that there is uncertainty when you read the
22 cases, whether the Brown Shoe factors are something that
23 gets you an ability to analyze whether a hypothetical
24 monopolist could, in fact, increase the price, or whether
25 the hypothetical monopolist test is, in fact, to some

1 extent, one of the Brown Shoe factors.

2 And you really see courts -- and I think this
3 is one of the problems, is that the courts really haven't
4 figured out where the hypothetical monopolist tests
5 relate to Brown Shoe.

6 I think that once you get outside of the merger
7 context, you see that a great number of courts, whether
8 in a Section 1 or a Section 2 context, where a definition
9 of the relevant market is important, are not in fact
10 looking at the hypothetical monopolist test, although it
11 clearly is an increasing trend to do so.

12 MR. WERDEN: All right. Let's try another
13 topic. An early criticism -- and not necessarily just an
14 early criticism -- of the 1982 merger guidelines approach
15 to market delineation was that it would systematically
16 bias the analysis -- yielding overly broad markets. And
17 hence, understating market shares.

18 I didn't think anybody believed that any more
19 until a week ago, when the American Antitrust Institute
20 released a statement in conjunction with this workshop,
21 which they officially filed with the Agencies as their
22 comments, which asserts "that there are common market
23 definition procedures" in the guidelines that "create the
24 potential for systematic errors in defining markets."
25 They don't explain.

1 But my question for the panel -- and I will
2 start with Will -- do you believe that the guidelines'
3 articulation of the hypothetical monopolist test gives
4 rise to the sort of systematic errors that people were
5 worried about back in the mid-1980s?

6 MR. TOM: Certainly to the extent that people
7 were worried about a systematic bias toward overly broad
8 markets, I think probably most perceptions of the time --
9 and certainly subsequent experience -- has shown that to
10 be completely unfounded.

11 I have suggested a reason in my opening remarks
12 why we might have a systematic bias toward overly narrow
13 markets. Not because of anything analytically wrong in
14 the guidelines, but simply because of some perhaps
15 unfortunate interaction between the guidelines and human
16 nature. That is the tendency to treat one side of the
17 equation or one hypothetical part of the analysis as fact
18 and another hypothetical part of the analysis as
19 speculative.

20 But other than that I don't see any particular
21 systematic biases at all.

22 MR. WERDEN: Can any of the panelists think of
23 any matter they worked on, or one they didn't work on,
24 where the guidelines, as opposed to some view of the
25 facts, led to a market that they thought was overly

1 broad?

2 MR. HARRIS: I'm not sure that I can answer
3 that, but a curious fact that I have raised with Greg in
4 a different context was -- must be 10 years now -- in the
5 Dubuque hospital case, there was an oddity there, and
6 that was that the lesser of the two hospitals in the
7 period before the merger had lowered their prices by
8 roughly 40 percent in an effort to get more patients and
9 get more managed care plans. And they had gotten
10 virtually nothing.

11 And for some reason, they left their prices
12 down. They had an experiment sitting out there that
13 said, oh, they could raise their prices 40 percent, get
14 back where they were, and presume the elasticity
15 symmetric, and they didn't do that.

16 So, that sort of raises the question -- and
17 it's not exactly your point -- but how low does the
18 market have to be in a situation like that to include the
19 merging parties? So it's sort of a related question.

20 An attempt to answer it directly, the only
21 thing that comes to mind -- and I didn't look into this,
22 and I may have the facts wrong -- but I have a memory of
23 the antacid case that had very, very different looking
24 competitors in there. And that might be a candidate for
25 a very broad market in which a case was brought on that

1 may or may not have been supported. But it's at least
2 one that comes to mind.

3 MR. WERDEN: We referred to that one as stomach
4 remedies.

5 MR. HARRIS: Okay.

6 MR. WERDEN: Because it included a lot more
7 than antacids.

8 MR. HARRIS: Yes. And again, I don't know the
9 process that got to the market, and I don't know very
10 much about the market, except that my doctor tells me to
11 take two every day for the calcium. I think that struck
12 a lot of people at the time, and it certainly struck me
13 at the time as being a market that was way too broad.
14 And that was based on just kind of being a consumer,
15 rather than any antitrust analysis.

16 But other than that, I am hard-pressed to think
17 of one.

18 MR. BLUMENTHAL: Well, I don't know that it's
19 possible for the guidelines, if applied literally, to
20 yield an overly broad market. It depends a little bit on
21 what we mean by overly broad.

22 But if the breadth from which you were either
23 too broad or too narrow is what you would otherwise get
24 by reference to the standards in the courts, the non-
25 guideline standards, it seems to me, as it does to Will,

1 that there is almost a chronic bias in the direction of
2 narrow markets.

3 Whether that's appropriate or not is something
4 we can talk about, but for 20 years I have been saying
5 that a 5 percent one-year test is going to lead to
6 markets that are a lot narrower than what business people
7 conventionally think of as being the market. And the
8 reason for that is that business people tend to take more
9 of a strategic perspective on things. And you don't see
10 a whole lot of shifting for five percent one year.

11 MR. WERDEN: Of course, it's not one year in
12 the 1992 guidelines, it's for the foreseeable future.

13 MR. BLUMENTHAL: Yes, foreseeable future. Fair
14 enough, fair enough.

15 MR. WERDEN: Okay. Do you have any theory for
16 why people like Bob Pitofsky thought what they thought?

17 MR. BLUMENTHAL: You know, I was not among
18 those who thought it at the time, and I didn't understand
19 it at the time. And I went in writing in the other
20 direction at the time.

21 Recalling the political climate in 1982, when
22 the guidelines were released, you know, as much as
23 anything else it seems to me sort of a knee-jerk reaction
24 to a perception that this was what some would have called
25 Reaganism run wild.

1 And that, from my perspective, at the time was
2 what was motivating it. And after the fact, 20 years
3 after the fact, that wasn't what was motivating it.
4 That's the best I can come up with.

5 MR. WERDEN: Okay, thanks. Next topic. A
6 long-standing issue in the application of a hypothetical
7 monopolist test is how to account for pre-merger
8 elevation of price above cost. The merger guidelines say
9 that we generally use the prevailing price, but there are
10 provisions in there referring to possibility of pre-
11 merger coordinated interaction that say maybe not.

12 The AAI statement that I alluded to a few
13 minutes ago issued last week argued as a general matter,
14 that the "use of the prevailing price should be carefully
15 evaluated in every merger investigation." And of course,
16 they didn't say what that evaluation might look like.

17 So, I am wondering what the panelists think
18 about this. And I will throw the first question out to
19 John. Assuming that by the term "competitive price" we
20 mean something like short-run marginal costs, which is
21 generally the way economists think of the term
22 "competitive price," do you think that that's really ever
23 the proper benchmark in a merger case?

24 MR. HARKRIDER: Well, I think that you can
25 think of -- I don't want to skip ahead in the question --

1 but you can think of many different contexts in which you
2 may be uncomfortable using the prevailing price, and I
3 think at least one context you're talking about is where
4 there is some evidence of pre-merger coordination.

5 And I think that you would want to use the
6 competitive price, as you defined it, if there were
7 evidence that absent that coordination or collusion, that
8 price -- that goods were, in fact, being sold at short-
9 run marginal cost, which may not be the case.

10 I think that I can imagine many instances in
11 which the prevailing price, but for coordination, may
12 not, in fact, be short-run marginal cost. And I would be
13 inherently suspicious of efforts to calculate short-run
14 marginal cost. That's both because the goods may not be
15 sold at that price, but also because people may be
16 relying upon accounting data in order to calculate it.

17 So I would be very nervous about agencies
18 trying to calculate that price, and then going to
19 customers and saying, "Okay, well, would you switch," in
20 response to a SSNIP on that.

21 So, I think the bias should be towards using
22 prevailing price, and I think you should use something
23 other than prevailing price and, in fact, the competitive
24 price as you defined it -- if there is evidence but for
25 collusion goods would be sold at that price.

1 MR. WERDEN: Well, that gets to the next
2 question, which is what is that evidence? What would
3 persuade you that but for the merger, some lower prices
4 have to prevail in the future?

5 MR. HARKRIDER: I would probably say some sort
6 of evidence -- I am generally a quantitative person. So
7 I would be looking towards what goods were being sold at
8 before the coordination. Or, in a market in which that
9 coordination doesn't exist.

10 MR. WERDEN: Well, you're apt to be hard-
11 pressed to figure out when the coordination started, or
12 to observe the industry in that kind of depth. So I
13 guess my question really is, since you don't know that
14 much about how coordination is going on -- because if you
15 did you would probably just refer this case over to the
16 criminal people and be done with it -- but it is your
17 observation that prices are awfully high here. So, you
18 know, something must be going on.

19 If that's the level of your analysis, how can
20 you incorporate that into some sort of conclusion about
21 what prices are likely to be, but for the merger?

22 MR. HARKRIDER: But I think that the government
23 has -- or the Agencies have -- a burden. And I think
24 that if you have no certainty that the price, but for the
25 prevailing price, but for the coordination, would be

1 short-run marginal costs, and it seems unclear why you
2 should be using that as the relevant benchmark.

3 I can also imagine industries where even in the
4 absence of coordination, because there are differentiated
5 products and there is some degree of market power
6 exercised by or held by each individual firm, that goods
7 would also not be sold at short-term marginal costs.

8 So, I just think it's very dangerous to have a
9 bunch of economists calculating what the price would be
10 without any clear evidence of what, in fact, the price
11 would be.

12 MR. WERDEN: Okay. In fact, the guidelines
13 don't use the competitive price as an alternative to the
14 prevailing price; they refer to the use of a price that
15 is -- I forget the phrase, but "closer to" is kind of the
16 concept -- the competitive price, i.e. a lower price.
17 And they don't say which one.

18 But, Will, I will put it to you now. If you
19 thought you had pre-merger coordination, and certainly it
20 is possible -- and that might even be the theory of the
21 case, that the merger may help that coordination persist
22 where it might not otherwise -- what price would you use?
23 How would you come up with some alternative?

24 And then if you did come up with some
25 alternative, how would you implement it?

1 MR. TOM: This is a hard question. I don't
2 think that we have got a lot of tools at our disposal to
3 create prices other than the prevailing price to use as
4 our benchmark.

5 I can think of some half-measures that one
6 might start with in appropriate cases. You know, one
7 thought experiment that is sometimes useful is to -- and
8 I credit Jon Baker for this -- is to say, what would
9 happen if prices were to fall five percent? And you
10 know, what products would exit the market?

11 And that may give you some feel for what a more
12 realistic market somewhat less affected by the Cellophane
13 fallacy would be. But if you start turning people loose
14 into trying to estimate what prices would be in a market
15 without the collusion, you're in a pretty tough spot.

16 And I guess the one other thing that occurs to
17 me is that the -- in some cases, you may be able to find
18 alternative explanations for prices seeming to be
19 unusually high. And I don't know if your hypothetical
20 was meant to exclude situations in which, for example,
21 the high prices are, you know, a return to the cost of
22 innovation, or things like that.

23 If you were intending to exclude that by
24 positing coordination, then I think you really are in a
25 fairly difficult spot where, you know, you really do need

1 to find some other price benchmark, but it's not obvious
2 what it is.

3 MR. HARRIS: May I?

4 MR. WERDEN: Yes, but let me throw one thing
5 out before.

6 MR. HARRIS: Go ahead, sure.

7 MR. WERDEN: I limited my question to the
8 scenario of pre-merger coordination because that is the
9 only scenario which the guidelines endorse using a price
10 other than the prevailing price. But if anybody wants to
11 suggest that there are other circumstances in which you
12 should do that too, feel free.

13 MR. HARRIS: I mean it strikes me in listening
14 to this that let's say you do have coordination, and
15 somehow you have reason to believe you have coordination.
16 Well, in effect, whether it's legal or illegal
17 coordination, you have what we were talking about before,
18 the price fix that defines the market for you.

19 So, it seems to me -- taking Greg's advice from
20 before -- is the market definition and the competitive
21 effects are two separate analyses. Well, from the pure
22 market definition point, if you really have coordination,
23 and you're in around where the monopolists would price,
24 well then you have kind of defined your market in
25 advance, and a further price increase would be going past

1 what the monopolist wants.

2 But when you're asking the competitive effects
3 question, it seems to me the question you want to ask is
4 is there something about this merger that makes it more
5 likely that you will be able to continue to coordinate.
6 But as far as the pure market definition point goes, I
7 think if you really understand that there is coordination
8 there, that, in effect, has defined the market for you.

9 MR. WERDEN: Thank you, Barry. Next question.
10 The hypothetical monopolist test, as articulated in the
11 merger guidelines, includes what's referred to in the
12 guidelines and elsewhere as the smallest market
13 principle.

14 Interestingly, in last week's AAI statement, it
15 is asserted without any elaboration: "The smallest
16 market principle should be deleted from the guidelines
17 entirely."

18 I want to throw out to the panelists whether
19 they think that makes any sense, and whether they are
20 inclined to make offensive use of the smallest market
21 principle. But I will start with a question to Barry.
22 Do you think the existence of the smallest market
23 principle in the guidelines has caused the agencies to
24 miss significant competition between the merging firms?

25 MR. HARRIS: I think the answer is no, and I

1 think the reason for that goes back to what Bill
2 Blumenthal said, and that is in the real world what the
3 agencies seem to do is they basically do a hunt to see
4 where the problem may be. And from -- and then they work
5 to an answer from that.

6 And I don't know that the narrowest market
7 principle really has much of an impact on how they
8 address the issues. How they present it is a different
9 question.

10 Another thing is -- maybe this is sort of a
11 question for Greg -- but I always thought of the
12 narrowest market principle as basically having two
13 different possibilities, one that I think is appropriate
14 and one that I think may not be.

15 The one that's appropriate would be, well,
16 let's say we have a well-defined market, the hypothetical
17 monopolists could raise price profitably. Let's just say
18 it's for cars, automobiles. And then the car monopolist
19 goes out and buys General Mills, as opposed to General
20 Motors, you know, making cookies and things.

21 Well, clearly, the analysis should be in the
22 car market, not in the car-plus-cookie market. But the
23 hypothetical car-plus-cookie monopolist certainly could
24 raise the price of cars. So, it struck me that the
25 narrowest market principle was intended to exclude those

1 kinds of circumstances.

2 What I think it doesn't exclude, and probably
3 should not exclude, is let's say there are a variety of
4 strategies that a hypothetical monopolist could take.
5 And one involves, let's say, four firms and a different
6 equally plausible strategy involves seven firms.

7 It would seem to me that there is a separate
8 market that would encompass, depending on what
9 competitive issue you're trying to address, would address
10 the four firms, and a separate one that would address the
11 seven firms. And I don't see that the narrowest market
12 definition says you can't look at the issues involving
13 the seven firms.

14 And again, it may have to do with differential
15 prices, or what's the next best alternative to the
16 hypothetical monopolist, rather than just the merging
17 parties, or things like that. But I don't see the
18 principle -- cutting it off at just the fourth firm
19 situation and saying you can't go look at the broader
20 market that includes seven.

21 MR. WERDEN: The 1982 and 1984 guidelines had a
22 lot of qualifying language in there about independent
23 competitive concerns in the larger market. That was
24 taken out in 1992. So the suggestion may be that you
25 can't look at that seven-firm market. But I think,

1 clearly, that hasn't been the practice.

2 John, a question for you. If you come in to
3 lobby the Agencies, are you prepared to try to use the
4 smallest market principle offensively and say that under
5 our own guidelines, the merging firms don't compete in
6 the same market?

7 MR. HARKRIDER: Yes, absolutely. I would have
8 no hesitation doing that. And let me give you two
9 examples where we have done that.

10 I have been involved in three scientific
11 journal mergers, all of which got similar requests, and I
12 know of a fourth. And in each one of those cases, it was
13 very clear that somebody who is buying a journal on brain
14 surgery is probably not going to switch to one on foot
15 surgery in response to a SSNIP. And if they do -- if
16 you're a patient, you're in a lot of trouble.

17 So, I think an argument can be made -- and a
18 very strong argument can be made -- that each one of
19 these scientific journals do not belong in the same
20 relevant market. That being said, and in due respect to
21 the Agency, in each case they were explaining a different
22 theory, which was a portfolio theory, where they weren't
23 necessarily looking at bundled goods, but they were
24 trying to figure out, okay, well, if you increase the
25 price of a very expensive journal, does this cause some

1 sort of externality that is, to some extent, outside of
2 that narrow market where the library, who is buying 1,000
3 journals, drops something else. It doesn't technically
4 compete.

5 I think that's an instance where the Agencies
6 didn't necessarily follow their guidelines but were
7 looking at competitive effects where they could find
8 them. And you know, thankfully, in each one of those
9 cases the government chose not to challenge the merger.

10 I think another instance where that occurs is
11 in software cases. I have definitely been involved --
12 and then gone down to the Agencies -- where my client may
13 have a sort of software, let's say, that does sort of
14 back-office sorts of things. And, within a given
15 industry, the company that we're acquiring has a software
16 that does front office sorts of things.

17 So, if you do sort of an analogy between, like,
18 Excel and Word, you know, both Excel and Word do some
19 sort of spell check, both Excel and Word allow you to add
20 and subtract and do little charts. But no one --
21 hopefully -- would say that they are in the same relevant
22 market -- at least if you're not looking at these things
23 as suites.

24 So, I think that you can definitely -- and at
25 least in the case that I'm talking about, a second

1 request was issued. And I think, for the purpose of
2 trying to figure out, well, do people buy these as
3 suites, are they within some broader relevant market.
4 But certainly, I think in highly differentiated goods,
5 especially with software goods, it frequently is the case
6 that goods may be either compliments -- but certainly not
7 substitutes, although it kind of looks to somebody who
8 doesn't know much about the products, that they compete.

9 MR. WERDEN: Were you successful in your
10 software argument to the Agency?

11 MR. HARKRIDER: Not successful in avoiding the
12 second request, at great expense to the client,
13 unfortunately. You know, we were successful at the end
14 of the day. A case wasn't brought.

15 MR. WERDEN: Well, that's what really matters,
16 isn't it?

17 MR. HARKRIDER: Yes, it is what really matters.

18 MR. WERDEN: You get to bill your hours, and --

19 MR. HARKRIDER: Well, no, that's not what
20 really matters. But I think that, you know, for those of
21 us that care a lot about the cost imposed on business
22 with respect to second requests, I think that, you know,
23 the scientific journal case is a very good example.

24 I mean, in the last 10 years there have been
25 four different second requests, all looking at the exact

1 same theory, where the guidelines, in fact, would seem to
2 suggest to you that the products don't compete.

3 MR. WERDEN: Well, I won't comment on what the
4 theory of any of those investigations was, because I
5 don't know. So, let's move on to another topic.

6 Section 1.11 of the guidelines states that what
7 constitutes small but significant non-transitory increase
8 in price will depend on the nature of the industry and
9 the Agency, at times, may use price increases larger or
10 smaller than 5 percent.

11 Will has already addressed this subject of
12 using price increases greater or less than five percent,
13 but there is one particular question I wanted to ask him
14 about on this subject that he didn't already address.
15 And that is the case of a low profit margin industry.

16 There is some commentary, including from Bob
17 Pitofsky, and some precedent -- I think all the FTC
18 supermarket cases, but I don't have any inside
19 information on that -- have used a price increase smaller
20 than five percent on the theory that it was appropriate
21 because profit margins were low.

22 Do you think that's right? What do you think
23 about the import, if any, of low profit margins?

24 MR. TOM: I wouldn't think that one should
25 systematically adopt a percentage increase less than five

1 percent in all low-profit margin industries. I would be
2 a little worried about the implications of that.

3 I in part, for the reasons that I articulated
4 earlier, which is you are getting down to finely granular
5 judgments about what the competitive effect is likely to
6 be in situations where the unknowability of it all may
7 simply swamp what you're trying to achieve.

8 And given the fact that we're dealing in an
9 area where there are very likely pro-competitive effects
10 from mergers, you know, I would be concerned about it. I
11 recognize the intuition on the other side is with profit
12 margins very low in an industry, you know, a relatively
13 small price increase is more significant to the players
14 in the industry.

15 But it's not obvious to me that catching the
16 additional mergers that might have anti-competitive
17 consequences in that circumstance is going to be worth
18 the risk of erring in the other direction.

19 MR. HARRIS: Think what's going on with
20 groceries. A very successful grocery store is going to
21 run maybe two percent return. And the reason for that is
22 they have to pay for all the products.

23 So, if you limit it to questions where you only
24 look at five-percent price increases, you have basically
25 almost created situations where entry is going to solve

1 all your problems. Because a five-percent price increase
2 is going to be increasing profits like three or four or
3 five-fold.

4 So, what that means is if you don't have some
5 flexibility in situations like this, you have basically
6 defined away those industries because basically, all the
7 problems are solved by entry in those kinds of markets.

8 MR. WERDEN: But there is no necessary reason
9 why the entry analysis has to perfectly parallel the
10 market delineation analysis.

11 MR. HARRIS: I --

12 MR. WERDEN: And the question I put was for
13 market delineation.

14 MR. HARRIS: I agree. But again, you have to
15 be careful how you use the market. If you're going to go
16 against what Tim Muris said and start talking about
17 shares and things in that market, those shares don't mean
18 a whole lot if you're looking at a five-percent price
19 increase, because entry or uncommitted entry, I mean,
20 depending on the circumstances, is very important.

21 That's going to drive the competitive analysis.
22 So I think almost as a way of screening within the
23 Agency, it seems to me more prudent to be looking at
24 smaller price increases and asking questions there. But
25 maybe not.

1 But it strikes me as a danger in setting five
2 percent as a threshold and not being able to do this type
3 of analysis in these kinds of industries -- not because
4 it's going through a cyclical margin, but rather because
5 it's inherent in the make-up of the particular industry.

6 MR. WERDEN: My suspicion is if one seriously
7 considered only a one or two percent price increase for
8 supermarkets, you would find that supermarkets a couple
9 of miles apart aren't in the same market, and that --
10 although I have never worked on a supermarket merger, I
11 have worked on a lot of local market retailing-type
12 mergers, and I can't imagine that you actually get the
13 right answer, in some sense, from using such a tiny price
14 increase, because you're going to keep the merging firms
15 from competing with each other.

16 MR. HARRIS: Actually, I didn't mean that you
17 wouldn't necessarily use one or two, I meant that you
18 shouldn't limit it to the use of five percent. So I
19 wasn't suggesting that should be a standard to only use
20 one or two. So I don't know that your comment actually
21 applies, then. Maybe I was just not clear.

22 MR. WERDEN: Okay. Well, thanks. Final topic
23 -- and Bill already touched on this quite a bit -- Brown
24 Shoe, I think perhaps more than any other case, holds
25 that you cannot challenge a horizontal merger without

1 pleading a relevant market, and coming up with some
2 shares, and et cetera, doing the structural analysis.

3 But that's a long time ago, and antitrust law
4 has evolved considerably. And in the Section 1 area, the
5 courts now pretty uniformly hold that you can do a rule
6 of reason analysis without defining a market.

7 So, my question is even though no court yet
8 hinted at the possibility of accepting a merger challenge
9 that doesn't involve market delineation, is sooner or
10 later that where the law is going?

11 And I will put the first question to John. Do
12 you believe that a court should, and separately would,
13 accept a merger challenge? And I will make it simple. I
14 will use a fairly straight-forward unilateral effects
15 analysis supported by some quantitative analysis, but
16 with no allegation of a relevant market.

17 MR. HARKRIDER: Well, I think the question is
18 when. If you do this tomorrow, will they accept it? I
19 would think probably not. I believe that it is very
20 important in merger policy to be both transparent and
21 predictable. I believe the courts are also aware of that
22 need.

23 I think the fact that the current guidelines at
24 least speak of market definition, and aren't entirely
25 clear on the issue of whether market definition is

1 necessary with respect to unilateral effects, and given
2 the line of commerce provision in the statute and the
3 Supreme Court's interpretation of that as requiring a
4 relevant market, I think that going into court in a
5 merger case without alleging a relevant market is
6 something you do at your peril.

7 So, I think that if the question is right now
8 is that going to be successful, I think absolutely not.
9 I think that if 10 years from now you have a period of
10 time where the merger guidelines have made it clear that
11 you do not need market definition, at least in the
12 context of unilateral effects so that there is at least
13 guideline precedent for that, I believe that there
14 probably is some probability, just like the hypothetical
15 monopolist test was accepted by the courts, that that
16 formulation would be accepted by the courts.

17 Even though, for example, Bill says that he
18 doesn't define relevant markets, at least at the lower
19 end, you still have safe harbors. I think that the safe
20 harbors are still things that people look at, especially
21 in the context of commodity goods, where there sort of is
22 an established precedent on what the relevant market is.
23 So I think it would send a very scary signal to the
24 business community that that market definition wasn't
25 necessary, and I think that you need to do so in very

1 slow steps.

2 MR. WERDEN: Go ahead.

3 MR. BLUMENTHAL: Can I just add one thing?

4 Just to be clear, what I said is I don't define markets
5 on the defense side. But I raise that not just to be
6 defensive here, but also to go on to say that on the
7 plaintiff's side it seems to me -- at least if you're a
8 private practitioner -- it's virtually malpractice per se
9 not to define a market, given where the courts are today.

10 And I would think that while the Agencies, as a
11 matter of not so much prosecutorial discretion, but as a
12 matter of wanting to move an enforcement program in a
13 particular direction, might try to do otherwise.

14 MR. HARKRIDER: I think that that's fair. And
15 while I do agree -- and I'm sure -- you know, obviously,
16 I can't speak for you, so I won't try to -- but while you
17 certainly say that you don't define relative markets, I
18 am sure you're aware of sort of the precedent.

19 For example, if you're doing a deal in
20 aluminum, or you're doing a deal in polypropylene, and
21 you may say to your client, "Okay, gee, there have been,
22 you know, 10 other cases either litigated or consent
23 decrees. The DOJ has defined the market, the FTC has
24 defined the market, and looking at our concentration
25 numbers, you know, we have a post-merger HHI of 1,000," I

1 would be very concerned that if, at the end of the day,
2 the Department of Justice said, "Okay, yes, I know. We
3 have defined markets this way and I know the guidelines
4 say that, you know, we have a post-merger HHI of, you
5 know, 35, but we're going to go and look to see if there
6 is a competitive effect," I just think, given the level,
7 there are, what, 2,000 HSR's that were filed last year,
8 there are 30 or 40 second requests. I would not want to
9 open up the possibility of second requests on the
10 balance.

11 MR. TOM: Can I just add one thing?

12 MR. WERDEN: Sure.

13 MR. TOM: While I agree with all that, I think
14 that the legal barrier to bringing a merger case without
15 defining a market is the -- "in any line of commerce, in
16 any section of the country," language in Section 7 of the
17 Clayton Act. Of course before there was a Section 7 of
18 the Clayton Act it was established that mergers could
19 also be challenged under Section 1 of the Sherman Act.
20 And the Supreme Court has now made clear that in
21 challenging conduct under Section 1 in the Sherman Act
22 you don't have to define a relevant market.

23 So, you know, if one were pressed to it, and if
24 one, for whatever reason -- which I'm having trouble
25 imagining -- I wanted to try to do a run around the case

1 law that says define a market in a merger case, there is
2 your precedent. Indiana Federation with the old Section
3 1 merger cases, and you have got a legal theory.

4 MR. WERDEN: And I could add that in the
5 Rockford hospital case, Posner held that the substantive
6 Section 1 standards for merger are identical to the
7 substantive Section 7 standards. So there is no higher
8 burden for the government if they went under Section 1,
9 at least if they went into the 7th circuit.

10 MR. TOM: Right.

11 MR. WERDEN: Let me, in the closing minutes,
12 pose a fall-back to going into court without a market.
13 And the fall-back is that instead of leading with the
14 market, you trail with it. You lead with your
15 competitive effects story -- and this is the way you
16 write your briefs, this is the way you try your case,
17 this is the way you do your oral argument.

18 Say, "Look, we've got this straight-forward
19 competitive effect story. Here is evidence that supports
20 it. And if you demand that we talk about markets, we
21 will, but we're also going to explain to you that it's
22 not really going to help you understand the story. In
23 fact, it's going to be affirmatively misleading, because
24 you could say the market is this, but that ignores this
25 factor; you could say the market is that, but that

1 suggests that somebody is more important than he really
2 is, et cetera."

3 What would you think about litigating a case
4 that way?

5 MR. HARKRIDER: Well, I would think that the
6 district court would be very concerned that if they
7 didn't start off with relevant market they probably would
8 run a significant chance of being overturned on appeal.

9 So I think that if you're end game is to get
10 away from relevant market, that's probably the first way
11 to start, so you could have a district court, say
12 something in what may effectively be -- you had to find a
13 relevant market, but it really wasn't necessary.

14 And that could be the first part of the step of
15 getting away from relevant market. I think that, as I
16 said before, if that's your goal, probably the way you're
17 suggesting it is the safe way to go, and I'm sure the
18 court, as the safe way to go, would probably say, "We
19 don't need to, but we're going to define a relevant
20 market in case you do think we need to."

21 MR. WERDEN: Anybody have any view on that?
22 Yes.

23 MR. BLUMENTHAL: Well, I think for the
24 foreseeable future, whatever the mode of analysis is
25 internally, by the time it gets to court it has to be

1 translated into the framework with which the court is
2 familiar.

3 And the way the jurisprudence on something like
4 this tends to evolve, the cutting edge stuff happens at
5 the Agency. It slowly seeps into the courts, but for a
6 long time, the courts hold to the old framework. And at
7 a certain point, some wise judge looks back and says,
8 "Look what we have been doing for the last 10 or 15
9 years, let me try to translate it in a way that is
10 consistent with what the Agencies are doing."

11 But for purposes of pleading, for purposes of
12 the theater of the courtroom, I would think that that
13 approach is still a little bit perilous.

14 MR. WERDEN: Okay. Well, I think we will end
15 it on that note. I thank our four panelists for an
16 interesting discussion, and that will conclude the first
17 session of the workshop.

18 (Applause.)

19 **(Whereupon, at 12:00 p.m., a**
20 **luncheon recess was taken.)**

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1 **A F T E R N O O N S E S S I O N**

2 MR. SIBLEY: I'm David Sibley, from the
3 Antitrust Division, and this particular panel is
4 concerned with the role, defined as broadly and vaguely
5 if you like, of concentration and market shares in
6 antitrust analysis as influenced by the data recently
7 released by the Agencies.

8 Now, we're going to have most of the
9 discussions structured around three questions. The first
10 one is: At some point in the future there is bound to be
11 a new version of the merger guidelines. Whenever that
12 is, what should future guidelines say on the subject of
13 concentration and market shares defined in any way you
14 want?

15 And John Kwoka, from Northeastern University,
16 and Steve Newborn are going to talk about that. And I
17 have encouraged them to use less than their usual amount
18 of gravitas, and try to seem a little bit extreme.

19 (Laughter.)

20 MR. SIBLEY: The second main question is do the
21 Agencies place too much or too little emphasis on market
22 shares and concentration when it comes to analyzing
23 mergers? And Rick Rule and Jan McDavid will be talking
24 about that.

25 Then Craig Newmark, with some kibitzing from

1 me, is going to talk about whether the empirical evidence
2 in economics relating prices to concentration and a bunch
3 of other things, or profits to concentration and a bunch
4 of other things, does that say anything very specific
5 about the extent to which concentration ought to underlie
6 the guidelines or underline merger policy?

7 And then finally, we're going to have a talk
8 from Vincent Verouden, from the EC, about the EC
9 guidelines and the way that those guidelines treat market
10 shares and concentration.

11 Now, with the exception of Vincent, who is
12 going to get 10 or 15 minutes to say what he wants to
13 say, the rest of them, in extremely impressive display of
14 ego on the conference call last week, suggested that each
15 speaker take maybe five or 10 minutes, and everybody else
16 pile on.

17 So, I am expecting great things from them. And
18 to sort of up the ante and make them feel as embarrassed
19 as possible if they don't come through for me here, I
20 will mention that at the beginning of this conference
21 call last week, when I had my sort of reasonable -- not
22 very inspired way of allocating speakers and time and
23 questions, someone -- in fact, everyone here has denied
24 that they are that someone -- said, "David, have you any
25 idea of the amount of ego on this conference call?"

1 So, that argues to me that these folks -- well,
2 if it was you, you must have had a cold, or tonsillitis.

3 MS. MCDAVID: No, it was Steve.

4 MR. SIBLEY: Okay. So, anyway, it's going to
5 be a little like an economic seminar at the University of
6 Chicago, where the speaker gets maybe 10 minutes, and
7 then the audience piles on.

8 So, with that, we will start with the first
9 question. What should future guidelines say about how
10 concentration and market shares are defined, analyzed,
11 used, whatever? And we will start off with John Kwoka.

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CONCENTRATION & MARKET SHARES

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2 MR. KWOKA: Out at the University of Chicago,
3 of course, David, you hardly get your name out before
4 people jump. But thank you very much. It's a privilege
5 and a great pleasure for me to be here to discuss some
6 aspects of the question of where we stand with regard to
7 one of the most prominent and perhaps most controversial
8 aspects of the merger guidelines. Namely, the role of
9 concentration and market shares.

10 I want to devote these few minutes to a couple
11 of issues that I hope go beyond some of the old debates.
12 There are really two disconnects that I see with regard
13 to economics versus the merger guidelines versus
14 enforcement policy.

15 The first of these is the growing disconnect, I
16 believe, between the way the guidelines are written and
17 what modern economics teaches about the anti-competitive
18 effects of mergers.

19 And the second is the disconnect between the
20 structural criteria in the guidelines and actual agency
21 action, which is underscored by the data recently
22 released by the Justice Department and the FTC.

23 So, in these few minutes I will try to
24 summarize these thoughts. I have more extensive written
25 remarks that are available in limited numbers in hard

1 copy here, but also will be posted on my website at
2 Northeastern University.

3 First, with regard to the guidelines and the
4 economics of mergers, I believe there are really three
5 major categories of competitive theories of the effects
6 of mergers: cooperative effects, the long-standing
7 notion of tacit or explicit agreement among parties;
8 unilateral effects, which has been in the guidelines now
9 for 10 years, but certainly has been an issue longer than
10 that; and strategic behavior.

11 Concentration is an important predictor of the
12 price effects of mergers when the concern is cooperation.
13 I think this is the implication of a wide range of
14 economic theories and has been confirmed by a large body
15 of empirical work. Neither theory nor empirical work is
16 without its limitations. Neither theory nor empirical
17 work implies precisely what level or change in
18 concentration matters.

19 Certainly none of it implies that any
20 concentration matters, and there is very little guidance
21 as to what the trade-offs may be with other causal
22 factors. This is a well-established relationship, I
23 believe, and lies at the heart of traditional merger
24 enforcement practices.

25 But concentration is much less important in the

1 case of unilateral effects. In the case of unilateral
2 effects, what matters is demand substitutability between
3 the merging firm's own products. Substitutability hinges
4 on elasticities. Those may be informed by diversion
5 ratios. And in turn, some light may be cast, under
6 certain conditions, on diversion ratios and elasticities,
7 by market shares.

8 So, that's an informational content to market
9 shares in the case of unilateral effects, but I believe
10 that their concentration plays no analogously important
11 role in theories of anti-competitive harm that derive
12 from unilateral effects.

13 In fact, there is a conceptual matter. The
14 guideline's exercises involving market definition,
15 product heterogeneity and entry conditions do not matter,
16 either. Careful measures of the relevant elasticities
17 incorporate essentially all of the information that one
18 would otherwise seek on those questions.

19 Thirdly, firms may engage in any competitive
20 conduct against their rivals. And merger may make this
21 more profitable, more feasible, and therefore, more
22 likely. Raising rival's cost, foreclosure, disciplining
23 behavior, and so forth, are different insofar as they do
24 not involve efforts directly to raise product price. But
25 rather, are intended to handicap rivals, and thereby

1 diminish their competitive effectiveness.

2 There is, of course, no unified theory of such
3 behavior, and so there is no simple enumeration of causal
4 factors. Concentration may matter, share may matter,
5 other factors may matter more in analyzing and predicting
6 the effects of mergers where strategic behavior is a
7 central concern.

8 These remarks themselves probably strike no one
9 as very novel, but the implication is that there really
10 are ways in which mergers may raise competitive concern.
11 Each, however, has its own distinctive set of factors
12 that we look to for analysis and prediction of those
13 effects.

14 That's not the way the guidelines read. The
15 guidelines set out a common methodology involving first
16 product and geographic market definition, identification
17 of participants, calculation of shares and concentration.

18 After that, we are supposed to come to a
19 determination of whether coordinated effects or
20 unilateral effects is the likely mechanism of concern.
21 But these steps I just enumerated are appropriate only if
22 coordination is the central concern. They are far less
23 so, if at all, in the case of unilateral effects. And
24 they are rather murky in their relationship to theories
25 of strategic behavior.

1 The present guidelines approach is, of course,
2 rooted in earlier versions that were explicitly and
3 exclusively concerned with coordination. But that
4 approach is not an equally logical statement with the
5 analytical process for mergers that involve unilateral
6 effects or strategic behavior.

7 What should be done? The problem is clear, but
8 the practice is a good deal less so. In principle, one
9 can envision a triage system, whereby there is a prior
10 determination of which theory of anti-competitive effect
11 is the concern. Cooperation, unilateral effects, or
12 strategic behavior. And then, based on that assessment,
13 one could set forth the relevant information and decision
14 rules appropriate to that category of concern, much as is
15 done now for coordinated effects.

16 Now, I recognize -- and my panel members here,
17 I'm sure, will be quick to explain -- the practical
18 problems with such a triage approach. And I do
19 understand that there is information value in some of the
20 other exercises that the guidelines suggest, even for
21 non-coordination concerns.

22 But I would urge that the logical structure of
23 the guidelines could be revisited so that the world of
24 concentration versus shares and other factors can be
25 better matched to each theory of competitive harm so as

1 to better inform outside observers as to the method of
2 analysis that compares with modern economics of mergers
3 effects.

4 The second disconnect, as I said at the outset,
5 that I would like to discuss briefly, stems from the fact
6 that the guidelines are supposed to inform outsiders as
7 to the criteria by which the Justice Department and
8 Federal Trade Commission evaluate those mergers.

9 That the guideline standards do not really
10 reflect Agency action has been no secret for quite a long
11 time. In December, the Justice Department and FTC
12 released data on their challenges to mergers, and early
13 this month the FTC released additional data on their
14 investigations and resulting cases.

15 The data offered considerable new insight into
16 enforcement practice, and raised some additional
17 questions about that enforcement. Merger challenges data
18 revealed that very few mergers with HHIs less than 2,000
19 are challenged, as are very few mergers with changes in
20 HHI less than 300.

21 In fact, more than three-quarters of all the
22 challenged mergers involve markets with HHIs in excess of
23 2,400 and simultaneously with changes in HHI greater than
24 500 points.

25 In these respects, the de facto standards

1 differ considerably from the thresholds written into the
2 guidelines. That is not such large news. There is
3 significant variation in these patterns by industry.
4 That, I believe, is to be expected, since the threshold
5 levels of concern under any theory -- for example,
6 cooperation -- should differ, depending on other factors
7 that arise that are specific to each industry.

8 The more recently released FTC data on
9 investigations in cases corroborate this impression of
10 enforcement as very heavily focused on large mergers in
11 the most concentrated industries. Very few
12 investigations of mergers in markets with HHIs less than
13 1,800 or changes in less than 200, for example, ever
14 result in cases.

15 For a closer and more systematic examination of
16 the likelihood that the Agency will bring an enforcement
17 action against mergers that are subject to investigation,
18 I have performed some regression analysis of these case-
19 bringing probabilities relating, essentially, the
20 fraction of investigations that result in cases to the
21 level of HHI and the changes in HHI caused by the merger.
22 This is, essentially, a straightforward examination of
23 the data in table 3.1 of the February FTC release.

24 The analysis essentially infers what criteria
25 the agencies use in coming to the point of an enforcement

1 action in a merger subject to investigation, and looks at
2 the relevant importance of the factors that do matter at
3 all.

4 The results demonstrate statistically that both
5 HHI and changes in HHI matter. That is, they affect the
6 probability of an enforcement action following an
7 investigation. The estimated coefficients imply that for
8 every 1,000 point higher HHI, there is an additional 5.75
9 percentage point risk that an investigated merger will
10 trigger an enforcement action. And every 1,000-point
11 greater increase in the change in HHI, results in an 8.5
12 percent added probability of a case.

13 Now, the results, which are explained in
14 greater detail in my written comments, can be used to
15 predict the probability that any investigated merger
16 might ultimately be subject to some enforcement action.
17 And they could also be used to define combinations of the
18 HHI and changes in HHI that result in a given probability
19 of enforcement.

20 The latter exercise is very close to a test of
21 whether the standards in the written guidelines in fact
22 reflect current agency enforcement. And once again, it
23 is no surprise to anyone that they do not.

24 While the statistical results imply bright
25 lines, of course, lines are not bright. Some

1 investigations above any line end up not resulting in
2 cases. And others -- at least a few -- below any line
3 you might draw occasionally, for good reason, do trigger
4 an enforcement action.

5 The data do not make clear which theory of
6 anti-competitive concern is at issue for any of the cases
7 that are enumerated in those data. Concentration matters
8 more for some theories, market share matters more for
9 other theories.

10 I think it would be useful to know, from the
11 FTC and hopefully from DOJ as well, what the relevant
12 theory is, so as to be better able to assess Agency
13 behavior against alternative theories of anti-competitive
14 harm. And I would urge both agencies to consider such a
15 breakdown in their future data releases.

16 Let me thank you again for the opportunity to
17 summarize these remarks.

18 MR. SIBLEY: Okay. Thank you, John. And you
19 may have noticed the recurrence of the phrase "may have"
20 a lot in John's remarks, so he is emphasizing subtleties
21 and fine distinctions, and sophisticated behavior by
22 firms.

23 Now, I hope we're going to get an opposing view
24 from Steve Newborn.

25 MR. NEWBORN: Well, I have no regressions to

1 run, sorry.

2 MR. SIBLEY: You're ahead of them already.

3 MR. NEWBORN: I have no website, either, I
4 don't think. But other than that, we don't disagree
5 horribly. I am very disappointed, John, that we don't,
6 because you seem to think predictability is very
7 important, and I was hoping that you were going to say
8 getting to the truth was more important. And my thesis
9 is that getting to the truth is far less important than
10 predictability, and that's what I want to explore today.

11 Now, you in the audience who are government
12 officials always know that we're supposed to say -- or I
13 was supposed to say once -- that, "The comments I'm about
14 to make are not necessarily those of the Agency or the
15 Department." I will just say that because David asked me
16 to take a rather extreme position, the comments I'm about
17 to make are not necessarily my own.

18 (Laughter.)

19 MR. NEWBORN: But having said that, I kind of
20 believe in this, that predictability is more important
21 than getting it right, and I believe that it's far more
22 important than getting it right. So, let me try to prove
23 that theory to you.

24 But by the way, by predictability, I mean that
25 businesses can, with intelligent lawyers at their side,

1 who are making a lot of money, predict the ability of to
2 the merger through. And by getting it right, I mean
3 there is some ethereal other dimension where economists
4 know this is the right way of doing it, and we should be
5 doing it this way. And I do believe predictability
6 outranks that getting it right.

7 So, why is predictability so important? By the
8 way, I wrote these notes down last night, so excuse me if
9 I'm a little disjointed. Why should we care about
10 predictability? And I always knew we should care about
11 predictability.

12 First of all, I will give you a few quotes in a
13 second about what the whole concept of the guidelines was
14 at the beginning, in 1982. I'm sure many of you -- I
15 think, Rick, you might have been there at that time, and
16 been part of it, but I think predictability is very
17 important to the business community for a number of
18 reasons.

19 One, a failed merger is a terrible thing. It's
20 just a terrible thing for the acquiring company. You
21 lose money, you lose time. But for the acquired company,
22 not only do you lose money and time, the morale of your
23 people is completely shot. You're losing business in the
24 marketplace. And in the extreme case, you fail. You
25 fail because you weren't able to predict whether or not

1 that merger could go through.

2 And therefore, predictability is so incredibly
3 important. And predictability is even more important
4 than that, because if you are doing a merger that
5 ultimately gets challenged, you're not doing a merger
6 that might not get challenged.

7 And if people believe -- and there are
8 economists in this room, I know, who believe -- that most
9 mergers are benign, and there are efficiencies to be
10 obtained in those mergers, you are losing the
11 opportunities of obtaining those efficiencies. Either
12 losing them because you're taking too long in your
13 earlier deal, or losing them completely because the
14 opportunity is gone, for one reason or another.

15 So, I think there is no doubt in my mind that
16 predictability is important. And of course, I wanted to
17 give you a couple of quotes from the versions of the
18 guidelines that show how important predictability was,
19 even in the 1984 guidelines.

20 And this is by -- I guess he was the Attorney
21 General, William French Smith. And he said, "The
22 principle of law embodied in the merger guidelines are
23 designed to give businessmen the certainty they need to
24 make legally correct and economically beneficial business
25 decisions.

1 In 1992 guidelines, which I was a small part
2 of, it says, "By stating its policy as simply and clearly
3 as possible, the Agency hopes to reduce the uncertainty
4 associated with enforcement of the antitrust laws in this
5 area."

6 And even in 1997, with the efficiency guideline
7 revision, it said, "By setting forth our policy as simply
8 and clearly as possible, the public better understands
9 how the government evaluates mergers, and firms have less
10 uncertainty about how the anti-trust laws will be
11 enforced, with respect to prospective mergers."

12 So, clearly, predictability is important in the
13 U.S. guidelines. But they are even equally important in
14 the EU-proposed guidelines. There are a number of
15 articles written that I found on the Internet this
16 morning that talk about one of the reasons they wanted
17 revised guidelines was to obtain the very predictability
18 they believe we have here, with our guidelines.

19 And it would be a shame -- and here is kind of
20 where I'm going with this -- it would be a shame to
21 change the guidelines. Not to tweak it, John, not to
22 tweak it and say, "Instead of 1,800 it's 2,400," or,
23 "Instead of 100 it's 300," because that really does
24 reflect Agency policy.

25 But it would be really a shame to change the

1 guidelines radically so that the new theory is not the
2 unilateral theory, or the close substitute theory, or the
3 coordination theory, as shown in our guidelines, but some
4 theory which sounds so good today, and tomorrow is going
5 to be rejected by the same person who authored it today,
6 because it doesn't make any sense.

7 So why are we considering radically changing
8 the guidelines -- and people are considering radically
9 changing the guidelines now.

10 So I think that we don't disagree, John. The
11 present guidelines, in numbers, do not reflect Agency
12 policy. But the present guidelines in concept absolutely
13 reflects Agency policy, as it should, and I have done a
14 million cases already and I haven't seen anyone go beyond
15 the guidelines, except one Justice Department case, which
16 I will have to talk to you about later, Dave.

17 People sometimes think that transparency is a
18 substitute for predictability, and it isn't.
19 Transparency, that is explaining why a particular case
20 was decided in this way -- for example, Jan got a great
21 case through the cruise line case, and there were, like,
22 five decisions, five statements by each commissioner
23 explaining that. And that's very helpful. Transparency
24 is very helpful.

25 But transparency does not equate to

1 predictability. Transparency is: "In this case we
2 deviated from our predictability because of A, B, C, and
3 D." Well, those complications make predictability a
4 joke. There is no predictability any more when you start
5 doing that.

6 So, despite the fact that it might hurt me in
7 the future -- and might hurt my clients -- I believe
8 predictability should be done. And if some new theory
9 has been proposed that indicates that there is no anti-
10 competitive effect from this merger, and therefore you
11 shouldn't challenge it, I think that theory better have
12 the test of time behind it before agencies decide to use
13 it and allow the deal to go through.

14 I think it's even more important -- and this is
15 really where I'm coming from -- when the market shares
16 are low, and the HHI under 1,800, every now and then the
17 agencies decide, "Well, we have a new theory, and we're
18 going to test it out on you." And although, generally,
19 that new theory is not tested, \$10 million have been
20 spent while they're considering this new theory.

21 My feeling is dump the new theory. It's not
22 important enough. Predictability is far more important
23 than that new theory. Even though there may be a slight
24 anti-competitive effect from this deal, the greater good
25 is that we can predict in the future that the 99.9

1 percent of the other deals that fall into that category
2 are not going to be challenged.

3 I don't want to go too much on this, because I
4 don't want people to come down on me -- but I have a
5 modest proposal that probably everyone is going to
6 disagree with. By the way, you know a modest proposal.
7 Most of you are literary types, and you know that
8 Jonathan Swift's "Modest Proposal" for eliminating the
9 population explosion in England -- or Scotland, maybe --
10 was for parents to eat their children.

11 And so, I don't propose quite that. My modest
12 proposal in changing the guidelines, though, is, I think,
13 a good one. But two parts. One part is pretty easy.
14 That is, the guidelines should not be modified
15 unilaterally by either the Department of Justice or the
16 Federal Trade Commission. It should be a joint effort.
17 I think that's great that they have joint guidelines. I
18 think it makes shopping -- although it exists and is
19 useful -- less useful, and that's important. But I think
20 that should be kind of the law of the land.

21 But my other proposal may be a little radical,
22 and that is I really do believe that the economic theory
23 du jour is only for the day, or it's only for the year,
24 it's only for the decade. It's going to change. And so,
25 why do we have to adopt it? I think it spoils the

1 predictability.

2 So, here is what I suggest to avoid that
3 happening. I think that if there is a new economic
4 theory that should be made as part of the horizontal
5 guidelines -- I am only talking about the horizontal
6 guidelines now; it should be proposed in one
7 administration, and accepted by the next administration.
8 That means the test of time has been met. Maybe we
9 should put it in the guidelines.

10 The last thing I want to say is that
11 predictability is not something peculiar to antitrust.
12 It's something that is important to law in general.

13 And I will read you just a short quote from
14 Lord Eldon. Lord Eldon was a judge in England, I guess
15 in 1803. And what he said was, in a very similar
16 situation, where people were talking about making sure
17 that things were kind of modified so that it would serve
18 the purpose for that particular case, he said, "It is
19 better that the law should be certain and perhaps wrong,
20 than that every judge should speculate upon improvements
21 in it."

22 MR. SIBLEY: Okay. Thanks very much. Now, at
23 this point, the panelists should feel free to say
24 whatever they like to. In fact, the audience should, as
25 well. So I will throw it open to everyone.

1 MS. MCDAVID: Well, as a practitioner, I second
2 what Steve says about predictability. It's very
3 important that the bar and our consulting economists be
4 able to give our clients guidance about the transactions
5 that are likely to succeed and the transactions that are
6 likely to fail, and those that may be worth taking a
7 chance on, because the ultimate gain and the client's
8 objectives in the transaction can be achieved, or may be
9 achieved.

10 The guidelines, in my view, have always
11 provided a useful framework, as opposed to a box to check
12 as part of one's analytics. And the framework gets
13 elaborated on in things like the statements that the
14 agencies issue, the decided cases, of which there are
15 many too few, and the speeches that the agencies give.
16 It's been known to those of us who do this work for a
17 long time that the statistics and the guidelines in the
18 HHI threshold were not the real thresholds, but we knew
19 roughly where the real thresholds were, even if they
20 weren't written down.

21 The interesting thing, I think as John pointed
22 out in some of his statistics, is how different they are
23 in some industries. Rick and I had a transaction where
24 they really did apply a 1,600 threshold, much to our
25 surprise.

1 So, I would second what Steve has said about
2 predictability, and tweaking around the edges, if we're
3 going to tweak.

4 MR. RULE: I think the lawyers are all going to
5 agree on predictability. In part, because, frankly, it
6 makes our job a little easier when we're advising
7 clients.

8 I will say -- and I think when Jan and I talk I
9 will say some more about this, but it's always struck me
10 that per se rules, particularly in this area, are
11 important, but they are important as safe harbors, not as
12 determinants of when a transaction gets challenged.

13 It's important to be able to tell your client,
14 a businessman or woman, "Look, if you're within this
15 range, unless there is some data that we didn't quite get
16 so that the market definition changes, or whatever, you
17 really don't have to worry very much about antitrust.
18 You can go worry about, the various other things that
19 stand in the way of putting a deal together.

20 It's less important, it's always been my view,
21 that number is not just a safe harbor; it's the line
22 between legality and illegality. Again, I will talk a
23 little bit more why I think an HHI is a bad determinant
24 of whether something is truly anti-competitive.

25 But my view has been -- and still is -- that

1 companies may decide that notwithstanding they are
2 outside a safe harbor, that there are reasons that the
3 transaction ought to be blessed, because it doesn't
4 threaten competition. And it's important in those cases
5 for the agencies to apply a fulsome and well-advised and
6 well-informed rule of reason analysis.

7 So that I agree 100 percent, it's very
8 important to understand the predictability of where the
9 safe harbors are. I would disagree a little bit in
10 saying that when you get beyond that, I don't think
11 predictability of knowing that the deal can't go forward
12 is the right way to go, because a lot of times business
13 people will decide that, "Yes, there are reasons that
14 this deal ought to make sense to the agencies, and we are
15 willing to take the risk that we can persuade them of
16 that."

17 And I think that the guidelines are good in
18 that sense -- allowing that sort of rule of reason
19 analysis when you get outside the thresholds. And I
20 think it would be a mistake to move away from that.

21 MR. SIBLEY: John?

22 MR. KWOKA: Let me take you up on your
23 challenge to be a little more provocative here, David. I
24 hear a round of endorsements of predictability, and there
25 is no quibble with that. The question, of course, is at

1 what cost do you achieve predictability.

2 What I haven't really heard expressed here is
3 what trade-off anyone thinks is an appropriate trade-off
4 for the virtue of predictability against getting the
5 story right. And I would offer, as evidence, that there
6 is an important trade-off there, the following two
7 observations. One is that a view of what the numerical
8 thresholds mean has surely changed between the 1968
9 guidelines and the present. If you want predictability,
10 take the 1968 guidelines.

11 The second factor is that there are new
12 theories, and some of them, like unilateral effects, have
13 wide acceptance in the economics community. And while
14 that adds unpredictability to the process, it does -- I
15 think in principle at least -- substantially improve the
16 likelihood of getting it right.

17 Those two factors I think prove that we do make
18 those choices between the continuum of getting it right
19 and predictability. And I would simply caution that we
20 need to think very carefully about the type of errors
21 being made for the virtue of predictability. I'm not
22 sure anyone would disagree with that, but I am also not
23 sure I am hearing people say that.

24 MS. MCDAVID: Well, I think in a way, David,
25 that takes us to the question that Rick and I were going

1 to talk about, because that takes us to the question of
2 what is the role of concentration.

3 MR. SIBLEY: Well, it does, but I want to
4 torment Steve a little bit here.

5 MS. MCDAVID: Okay, go right ahead.

6 MR. NEWBORN: No, not tormented at all. I was
7 kind of hoping no one would put their finger on that
8 particular matter. Of course we're always making that
9 choice between predictability and getting things right.

10 And you're right, I wasn't thinking of the 1968
11 guidelines so much for predictability, I was thinking of
12 the practice that, as Justice Stewart said, government
13 always wins. That's the only universality in the 1960s.

14 But having said that, I guess my point is not
15 that we don't change. My point is that we change only
16 for a very good reason, and the reason I haven't seen an
17 economic theory -- not that I would understand it if I
18 did see it, I might add -- but I haven't seen a consensus
19 behind any economic theory that's greater than that in
20 the guidelines right now. And when we do, I think my
21 modest proposal should be invoked.

22 MS. MCDAVID: And the data that were put out by
23 the FTC a couple of weeks ago also show that almost as
24 important as concentration levels and increases in
25 concentration levels are the factors like the existence

1 or non-existence of a complaining customer and the
2 existence or non-existence of hot documents. And those
3 may be as outcome-determinative as concentration levels.

4 My guess is this 1,400 case that you have
5 pointed out John, in your statistics, had oodles of both.

6 MR. SIBLEY: Now, that sort of bright line
7 stand may also run into problems with one of Rick's, you
8 know, favorite clients. Microsoft and other firms are
9 what we would call members of network industries, where
10 the more people that use a product, the more it becomes
11 useful. In cases like that you would expect market
12 shares of these successful firms to be extremely high.

13 And whatever bright line thresholds might be
14 for the cement industry, they might be unduly
15 constraining for a network-type industry.

16 MR. RULE: Right. And that certainly is true.
17 The one point I was going to make is -- in response to
18 John's -- it is certainly true that guidelines that
19 generate false negatives have a cost. The thing that
20 certainly has never been done -- maybe it's just because
21 it's impossible to be done -- is some analysis that
22 suggests that -- let's just take a number -- mergers that
23 result in HHIs of above 2,000 and an increase of greater
24 than 50 but less than 200 somehow have generated any
25 economic harm.

1 I don't know of any evidence to suggest that is
2 true. And I certainly haven't heard of any evidence that
3 would suggest that if you use the current thresholds,
4 that transactions that aren't brought have generated any
5 economic harm.

6 Indeed, I am not sure I am aware of an example
7 -- but maybe you can enlighten me -- of a single merger
8 that fell in those areas where an economist has been able
9 to show, going back, that there has been harm.

10 Now, there had been harm, arguably, from
11 certain transactions that were consummated. But
12 typically, if you go back and look at those, at the time
13 they were consummated for various reasons the Agency let
14 them go, even though the HHIs were greatly exceeded.

15 So, while I think John is right, I think we
16 always have to be worried about false negatives. I think
17 the cost to the economy of those has never really been
18 established, there has never been a study that says that.

19 And I think if one moved -- as we will talk
20 about -- moved the thresholds up substantially but
21 maintained that predictability, I think the burden would
22 be on those who wouldn't move it up to prove that the
23 cost to the economy would be great. And I just don't
24 think the evidence is there.

25 MR. SIBLEY: Let me sort of make a comment, and

1 then sort of take a poll amongst the panel members here.
2 The comment is I am sure you're right, that there hasn't
3 been a well-done, carefully done economic study that
4 demonstrates that a particular merger, which was allowed
5 to take place, shouldn't have been.

6 But you know, that's partly because the only
7 way you would get such information is if you had the sort
8 of CID power to get data that you do prior to a merger,
9 except I think the FTC does have some powers in that area
10 that the Justice Department doesn't. But that's got to
11 be part of the reason why such data don't exist. It's
12 not to say people have looked at it, it's just not there.

13 MR. RULE: Right. But if it was systemic in
14 the sense that the guidelines set thresholds that were
15 too low or too high, and systemically, transactions that
16 were really harming the economy were getting through, you
17 would think that there would be a way to evaluate that
18 and measure that.

19 And my point is I don't really know of anybody
20 who has successfully posited that. That doesn't mean
21 that there may not be outliers somewhere. But the fact
22 is that if there are a few outliers, or a few bad
23 transactions, or transactions that are sufficiently
24 unique that it causes harm, to me that doesn't say
25 anything except that yes, there is a cost to everything,

1 there is a cost to predictability.

2 But if it's only slight, and it's only a few
3 aberrations, then it's not something that we ought to be
4 terribly concerned about.

5 MR. SIBLEY: Let me ask Steve a bit more about
6 predictability here. Certainly one aspect of
7 predictability are specific numbers, like, say, what a
8 safe harbor would be.

9 Now, in that sense, the guidelines are
10 extremely predictable. Now, there are lots of other
11 things that we look at all the time with mergers, which
12 are not numerical, but nonetheless you can see them
13 listed as factors that we might take it into our heads to
14 think about.

15 Would the guidelines become less bright line if
16 following John's suggestion, we thought of four or five
17 things that had to do with firms' strategic behavior to
18 make other firms less competitive, that might conceivably
19 be enhanced by a merger? Is that just sort of too much?

20 MR. NEWBORN: Well, I was going to say that
21 there were two points I would make, two observations, as
22 someone once said.

23 One is that, obviously, the more factors you
24 put in there, the less predictable one would think it
25 would be, unless those factors are measurable, and you

1 could make it even more predictable with more factors. I
2 mean, you could construct something where you have 40
3 factors and they are all measurable, and you know your
4 deal is going to go through or not.

5 That's not what you're thinking of. You're
6 thinking of five more variables that one has to think
7 about before you know whether or not the deals go
8 through. I suspect that would make it less predictable,
9 but not significantly less predictable, unless they were
10 broad.

11 Second thing I think it's important -- and Rick
12 put his finger on it I think, or at least implied it --
13 is that predictability is most important when we're
14 talking about safe harbors. When I talked about a high
15 predictability for high HHI mergers, that's one thing.
16 And I actually would give ground on that one, because I
17 understand that companies, as long as it's not a hostile
18 deal, can make intelligent decisions as to whether or not
19 they're willing to undergo this process.

20 However, for low HHI deals, for safe harbor
21 deals, I think the Agency should just cut it off if it's
22 1,800 or less, or less than 2,200 in the new guidelines,
23 whatever they are, there should be no new theory coming
24 up to implode in the faces of those people who went down
25 this road thinking there was no problem at all.

1 I think that's very important, and I really
2 think that both the Justice Department in a case I did
3 last summer, the FTC in a case I'm doing right now are
4 both exploring those type of theories, and I think it's
5 just the wrong thing to do, for the reasons we have
6 talked about.

7 I will give you one more quote, because I love
8 quotes. This is from the european round table, and they
9 were trying to figure out why predictability is
10 important. I just found this now, so I haven't explored
11 it too much -- but they go so far as to say, in light of
12 the new EU guidelines, the stability of the framework
13 within which companies act is decisive for economic
14 growth and development.

15 So, I think the more predictability we get --
16 and I want to be more provocative now -- despite the fact
17 that we're pretty sure the economic theory we're working
18 under now in the guidelines is wrong, is what we should
19 be seeking, rather than going further to some ethereal
20 feeling of --

21 MR. SIBLEY: Okay. We do need to move on to
22 the next topic. Now, in fact -- you have all fulfilled
23 the promise you made to me to talk a lot -- but before we
24 do, I would sort of like to poll you on whether the safe
25 harbor should be raised from 1,800 to, let's say, 2,200.

1 Starting at this end, Craig, do you have any
2 views on that? I guess, judging from your paper, you
3 can't, actually, but --

4 MR. NEWMARK: Yes, I would say I don't have
5 enough evidence to know, and I would adopt Steven's point
6 that if I don't, then I should stick with what we have
7 got.

8 MR. SIBLEY: Okay. Steven?

9 MR. NEWBORN: Okay, and I am going to deviate
10 from my point, since I don't care what the evidence is.
11 Since the policy of the Agency is clearly to not
12 challenge deals in the 2,200 or under range, let's make
13 it 2,200, and start anew.

14 MR. SIBLEY: Stop pretending?

15 MR. NEWBORN: Yes, stop pretending.

16 MR. SIBLEY: Yes.

17 MS. MCDAVID: It matters less to me what the
18 exact number is than that we understand what role it's
19 serving so that we can take it into account in our
20 counseling, for the reasons that I am going to explain.

21 I would probably raise the break-point more to
22 around 1,800.

23 MR. SIBLEY: Okay. When you talk about
24 clarifying the role, do you mean that you want to
25 distinguish between a bright line in the sense of go or

1 no go, or bright line in the sense of safe harbor, and
2 take your chances after that?

3 MS. MCDAVID: In the sense of where do I expect
4 that the Agency is going to focus.

5 MR. SIBLEY: Mm-hmm, okay.

6 MS. MCDAVID: First screen.

7 MR. KWOKA: Two comments. One is that I think
8 that some relaxation of the standard is probably
9 appropriate. It certainly would reflect Agency action.
10 Whether that's an iron-clad irrebuttable safe harbor I
11 think moves into my second point, and that is that we
12 have continued to discuss this as if only concentration
13 mattered.

14 And as I stress, for unilateral effects that
15 ain't really what's most important.

16 MR. SIBLEY: Give an example of that. I meant
17 to ask you about that.

18 MR. KWOKA: Well, it seems to me that for
19 unilateral effects, one is concerned about firms with
20 particular configuration of their products and product
21 space -- demand substitution is particularly strong. So
22 the acquisition of one by the other internalizes the
23 profit loss that otherwise would occur.

24 That really is a phenomena that focuses
25 attention on their market shares -- though, admittedly,

1 even defining markets in that context is a bit dicey.
2 But one can bite the bullet and perform such aggregations
3 and calculations.

4 My point is, however, that the anti-competitive
5 effect is really much more a function of if you had them,
6 the elasticities, or if you don't have them, diversion
7 ratios. If you don't have those, then market shares will
8 give you some information.

9 But it doesn't really depend on the broader
10 level of concentration in the industry, because it does
11 not presume, does not focus on the prospects of
12 coordinated behavior amongst a larger number of parties
13 in the industry. That's not the competitive theory.

14 And so, you know, in response to Steve's point,
15 too, the safe harbor for coordinated effects may well
16 deserve to be higher, but interpreting that as a safe
17 harbor against all anti-competitive theories of mergers
18 is really to potentially give some firms a pass when the
19 concern is really with unilateral effects localized and
20 measured, to some degree, by their respective market
21 shares.

22 MR. SIBLEY: Okay. Rick?

23 MR. RULE: Let me hold that until I get to my
24 remarks, and then address that there.

25 MR. SIBLEY: Okay. Vincent, anything you want

1 to say at this point?

2 MR. VEROUDEN: Yes. The same for me, I guess.
3 It's not really for me to say in what direction the U.S.
4 guidelines should go.

5 MR. SIBLEY: Of course.

6 MR. VEROUDEN: Well, I could say at this point
7 that actually we have adopted what one could call a safe
8 harbor approach in the EU guidelines with respect to HHI,
9 and the level is 2,000. That's the only thing I would
10 like to say at this moment.

11 MR. SIBLEY: All right. The next question,
12 some variation of do the agencies place too much or too
13 little reliance on shares and concentration, and the
14 lead-off hitters there will be Jan McDavid and Rick Rule.
15 We will start with Jan.

16 MS. MCDAVID: My view in merger analysis is
17 that it does no more than set the stage for us.

18 One of my concerns about concentration for
19 years is that it creates a false and artificial sense of
20 precision that doesn't actually exist in a transaction.

21 You start with the fact that it's based on
22 market definition. Market definition is rarely as
23 precise as a lot of lawyers and economists might pretend
24 it would be. There is a lot of movement at the edges.

25 For example, in the Carnival Cruise lines case

1 that Steve referred to, if the market were defined as
2 cruise lines, the market shares were very high. If the
3 market were defined as all vacations, the market shares
4 were very low.

5 The Agency defined a market of cruise lines,
6 and let the transaction go, in part, because they thought
7 the definition was really pretty squishy and not
8 particularly accurate. So you start with the fact that
9 market definition is a scientific thing. Market shares
10 aren't scientific.

11 How do you measure them? Are they based on
12 capacity? Are they based on unit sales? Are they based
13 on dollar sales? And then the numbers we have are rarely
14 completely accurate. When you square them, it's no more
15 accurate than where you started. It's just that you're
16 doing math. And because it's math, a lot of people think
17 it really matters.

18 MR. SIBLEY: Actually, when you square them,
19 that means the inaccuracies go up.

20 (Laughter.)

21 MS. MCDAVID: Yes, that's true. So, in
22 practice, when I'm doing transactions -- with rare
23 exceptions, and cruise lines was one where we argued for
24 a broader market definition, and I think the other
25 economic data substantiated that -- I rarely define

1 markets, I rarely present HHI calculations to the
2 agencies. I use them in understanding whether this is a
3 transaction on which the agencies are likely to focus and
4 devote resources, or is it a transaction that's likely to
5 get a pretty easy pass.

6 There is no bright line that separates those
7 deals, and there is no industry, as the data that have
8 been presented by the FTC and the Justice Department
9 show, where the numbers are absolutely critical. This is
10 a game that we play between the 20-yard lines on either
11 end of the field. And what the concentration statistics
12 give me is the ability to determine whether I am between
13 the 20-yard lines or in the red zone on either side.

14 There are benchmarks that are useful for the
15 bar to explain to our clients to understand the
16 transactions that deserve further analysis. And the
17 guidelines actually make this point themselves in the
18 introduction, where they say, "Mechanical application may
19 provide misleading answers." And the guidelines should
20 be applied reasonably and flexibly to particular facts
21 and circumstances.

22 So, the role that I use the guidelines for, and
23 I think the role that the agencies actually use the
24 guidelines for, is to provide a framework for analyzing
25 the transactions on which additional work is desirable.

1 And then we get to the fun part, and that's all of the
2 other factors that are in the guidelines, which really
3 are the outcome-determinative issues in most instances.

4 Is entry possible? What are the
5 characteristics of the buyer? What's the nature of the
6 product? Is demand lumpy? Is there a General Dynamics
7 defense that would suggest that market shares of the past
8 are not indicative of ongoing future market conditions?
9 Is one of the firms failing?

10 Is there some other fun fact about the
11 particular industry that means that the statistics that
12 provide, in my view, an interesting and useful first
13 screen for both the agencies, in terms of where they
14 devote their resources, and the bar and the business
15 community, in terms of the transactions on which they're
16 prepared to devote resources where we can start playing
17 with all of the other factors, which is where the game
18 really gets decided.

19 MR. SIBLEY: Rick?

20 MR. RULE: Thank you. When asked to
21 participate in this, and after our little conference
22 call, it seemed to me that we ought to subtitle this --
23 and I'm even more convinced of that after hearing what's
24 been said so far -- "Lies, Damn Lies, and Statistics."

25 It is the latter category, the worst and the

1 least reliable that HHIs fit into. A couple of anecdotes
2 are kind of interesting in terms of understanding the
3 guideline's numbers.

4 When Baxter set about rewriting the guidelines
5 I was not actually there. I came shortly after they were
6 published, and then wasn't involved in the 1984 revision.
7 But the story was that Baxter initially set out to find
8 the magic number.

9 He told Tyler Baker, who was the special
10 assistant who was focusing on the guidelines, to go off
11 and figure out a way to incorporate all of the relevant
12 factors and come up with a number that would determine
13 whether or not a merger would pass or fail -- at least
14 that's what I have been told. Of course, Baxter couldn't
15 find the magic number.

16 One of the innovations, though, that he did
17 come up with was the HHI number, as opposed to
18 four/eight-firm concentration ratios, which were what had
19 been used in the 1968 guidelines. And that was
20 considered a great innovation. People didn't know what
21 it meant, and it seemed like this really great economic
22 statistic named after two guys nobody else knows what
23 they do, except I'm sure the other economists here. And
24 they sort of implemented those.

25 But ironically, because they thought that was

1 pretty innovative, and there are a lot of other
2 innovations -- at least since I have been told -- that
3 the thresholds that were used in the 1982 guidelines
4 were, in some ways, designed to sort of mimic the four
5 and eight-firm concentration ratio thresholds in the 1968
6 guidelines.

7 So, you know, if you thought that Baxter, as
8 smart as he was, and all the folks around him, and Greg
9 Werden, and everybody else sat around and really came up
10 with a great new idea about where the thresholds ought to
11 be, think again. It was really Don Turner, and God knows
12 how he came up with the 1968 guideline thresholds.

13 And finally, in the mid to late 1980s, you
14 know, we just sort of took the guidelines. And at that
15 point I think we viewed the thresholds as safe harbors,
16 and then if you got past them, the government would look
17 at all of the factors, the ones that Jan talked about and
18 other things, to try to determine whether or not there
19 was a threat to competition.

20 But we kept hearing these stories about
21 practitioners who would sit around once a week and have a
22 meeting, and try to come up with the new secret
23 guidelines numbers.

24 And apparently, the number was fluctuating all
25 over the place, and it always kind of amused us because,

1 you know, other than sort of getting into the process of
2 understanding what deals we should look at and what we
3 shouldn't look at, and to some extent trying to
4 understand what the dynamics of the market were, we
5 certainly didn't have any secret guidelines that we were
6 operating on the basis of.

7 With that as background, I would say that there
8 are definitely weaknesses to concentration ratios. I
9 think they have been discussed here. Even theoretically,
10 as John has pointed out, market shares and concentration
11 ratios are proxies for a particular harm. I do think the
12 HHIs are a better number because, to some extent, they
13 reflect unilateral market power -- at least indirectly.
14 But even theoretically, I don't think any economist would
15 say that they are the end-all be-all.

16 Moreover, as Jan has pointed out, there is a
17 lot of subjectivity in terms of the calculations: market
18 definition; the data, frankly, which is one of my pet
19 peeves in diversion analysis and residual demand
20 analysis, which I think sometimes leads to a number that
21 economists like to think has some concreteness to it, but
22 in fact, I think often is a reflection of poor data.

23 So, there are data problems, and then you have
24 got the fact, as I said, that the thresholds are
25 arbitrary. And notwithstanding the decision in 1982 to

1 follow the 1968 guidelines, and notwithstanding that
2 everybody sort of understood that nobody was
3 realistically going to bring a merger case that had a
4 post-merger HHI of 1,001 and an increase of 150, nobody
5 had the political courage in 1984 or 1992 or thereafter
6 to raise the thresholds. And I think there is a question
7 as to whether or not they would do it today.

8 So, as a practical matter, those are purely
9 arbitrary numbers. They probably always will be purely
10 arbitrary numbers, but that's why I go back to the point
11 that I made with John, that, in having predictability
12 there is always going to be an element of arbitrariness.
13 And I think the burden is on those who would say that,
14 "Gee, the thresholds are wrong, and there is a lot of
15 harm being done to the economy" to prove that if they
16 want to change the thresholds.

17 So, you know, I think that's the situation.
18 The bottom line is that it's bad to use concentration
19 numbers to decide whether to block a merger. Again, I
20 don't think that at least since the mid-1980s, that the
21 agencies have relied on numbers to block transactions.

22 I think since, really, around the mid-1980s,
23 what's really become important is looking at all the
24 factors and engaging in a pretty fulsome rule of reason
25 analysis to analyze a deal. I think that as Janet

1 pointed out, if you look at the FTC numbers, there are
2 factors, principally the two that Jan mentioned, customer
3 complaints and hot documents, which probably play a much
4 more significant role when there is actually a
5 significant investigation. But there are other factors.

6 Now, having said that, again, as we have
7 discussed, that doesn't mean that the numbers are
8 irrelevant. They are important to predictability and
9 they should be around. That, then, brings me to the
10 question of whether or not there should be an update.

11 I generally think that there probably ought to
12 be. I mean, there is always a downside to getting into
13 too much changing of guidelines. It's never easy to
14 write guidelines, it's become more complex when you get
15 the FTC involved. But I do think the numbers ought to be
16 updated, and I think the statistics that were published
17 support that.

18 At the very least, it seems to me that those
19 statistics indicate that the thresholds should be post-
20 merger HHIs of greater than 2,000, and changes in the HHI
21 of greater than 200, because if you take out petroleum
22 mergers and banking mergers, then you will see that less
23 than 2 percent of the challenges came below those ranges.

24 And frankly, from my perspective, you could
25 probably raise the thresholds to greater than 2,400 and

1 greater than 300, and again, you would only be cutting
2 off a little bit more than 10 percent of the transactions
3 that are challenged.

4 I think when you look at those numbers, you
5 really do have to throw out petroleum mergers and banking
6 mergers. I'm not quite sure what fever afflicted the FTC
7 in the late 1990s about petroleum mergers, but they acted
8 way too emotionally, and I don't think based on very
9 sound evidence in the way they defined certain markets
10 and the challenges that they brought, particularly in
11 local petroleum retailing and wholesaling markets.

12 Jan and I were victimized by that, but I don't
13 think there really was a very credible theory, and it was
14 just more or less a concern about changing times.

15 Banking, as anybody who has been in the
16 Department knows, is an exception. They basically send a
17 letter off and indicate they have got a problem. And the
18 way bank mergers have been analyzed for the last 20 years
19 is pretty much by rote, using numbers.

20 Arguably, the Department ought to update its
21 practice, but the result of that is that, you know,
22 banking mergers are handled much differently from all
23 other mergers. And if you take those out, then I think
24 that the case is extremely compelling, based on the
25 practice of the agencies, that the thresholds really are

1 too low and ought to be 2,000 and greater than 200.

2 And the final point that I would make is -- we
3 haven't discussed it, but it's real relevant to what John
4 talked about -- the merger guidelines have not been
5 updated with respect to non-horizontal merger concerns
6 since 1982.

7 And if you go back and look at those, even the
8 theories and the sort of analysis on which they're based,
9 you could defend them maybe, but they certainly reflect
10 nothing of the concerns that the agencies have when they
11 have looked at those mergers. And there is literally no
12 guidance provided by the merger guidelines, in terms of
13 non-horizontal merger concerns.

14 And it's something that the agencies ought to
15 look at, and I think they ought to work on trying to
16 develop thresholds, safe harbors, that practitioners can
17 use to know when a deal is clearly not going to raise a
18 vertical or non-horizontal problem.

19 MR. SIBLEY: I would like to just comment on
20 the last thing that Rick said about looking at non-
21 horizontal mergers, and this is really quite an
22 interesting area. Over the last roughly five to 10
23 years, there have been some nice new papers in economics
24 which have looked at that.

25 And the general theory, the sort of intuition

1 behind them is that you can imagine the situation where
2 we have two upstream suppliers of an input to a pair of
3 downstream firms. If there is a vertical merger, you can
4 imagine the situation where the remaining un-merged,
5 downstream firm chooses to buy from the upstream division
6 of the new merged firm at an inflated price, instead of
7 buying from the unintegrated upstream firm at a lower
8 price, solely because that reduces the incentives of the
9 merged firm to compete on price very vigorously
10 downstream.

11 There are lots of very nice intuitions that
12 way. It is not easy, I would say -- speaking as one who
13 spent as much as a half-hour trying -- to come up with
14 ways of sort of making these theories testable. But they
15 certainly are intriguing.

16 Okay. Any other comments on these remarks?

17 MR. KWOKA: Let me offer a couple of
18 observations on Rick's very thoughtful comments. One is
19 that there is probably no more sweeping expression of the
20 value of predictability than critical values in
21 concentration ratios.

22 Because apart from safe harbors, the rest of
23 what, the guidelines have said does not represent
24 statistically observable bright lines in the empirical
25 work and economics.

1 I think Craig will talk about some of that
2 work, and there are suggestions in the literature -- to
3 which, once upon a time, I contributed a modest amount
4 myself -- that shows that there may be some indication of
5 break points at 35 percent for two-firm ratios, or 50
6 percent for four-firm ratios, and all of that. Many of
7 us are familiar with those.

8 But one would not predicate sound economic
9 policy on the belief that those really are hard and fast
10 break-points in behavior. The very point of the
11 guidelines is to enumerate all the other factors that
12 bore those lines. We understand the importance of those
13 other factors.

14 But there is value, nonetheless, to break-
15 points, or articulating something as simply raising
16 degrees of concern, but not necessarily tipping a merger
17 from one category unambiguously over into another.

18 Another comment that Rick has made a couple of
19 times now concerns the lack of proof that some mergers
20 that have been allowed to occur may have caused harm.

21 You know, it's a concern of many of us
22 empirical industrial organization types that there really
23 aren't very many studies of the effects of consummated
24 mergers showing their anti-competitive effect, and there
25 are few. There are not none, but there are few.

1 There are reasons for that, methodological
2 reasons for that. And I think the methodological reasons
3 are, in the first instance, the explanation rather than
4 the substantive conclusion that there are no such
5 anticompetitive mergers, that have been allowed to occur.

6 Let me just take a moment and sort of contrast
7 this with a kind of standard exercise in empirical
8 economics, where one looks at the impact of, say, a
9 regime change, a deregulation in an industry, looking at
10 the effects of a merger is really very much different.

11 You don't have a whole industry, you have an
12 individual firm. The signal to noise ratio in your data
13 is much lower. There are many other contravening factors
14 affecting an individual firm's experience that make it
15 far more difficult to tease out, convincingly, the
16 effects of merger versus all the other influences that
17 occur.

18 You never have -- or rarely have -- kind of
19 cross-sectional observations. You are forced to deal
20 with time series and all the other myriad influences that
21 affect the productivity, profitability, margins,
22 whatever, of a firm come into play, and that's unlike our
23 standard comparison exercises, looking at the value, say,
24 or effects of deregulation.

25 But it does mean -- and with this I certainly

1 would agree -- that there are too few follow-up analyses
2 of the consequences of consummated mergers for us
3 reliably to know precisely what to conclude about the
4 impact of policy decisions not to act.

5 MS. MCDAVID: But as David pointed out, the
6 Federal Trade Commission has done a few retrospective
7 analyses, and I have always found them extremely useful.
8 And we may have the opportunity to see more as the
9 records in the cases that they have been litigating
10 involving closed mergers become available.

11 The most recent Evanston hospital decision, and
12 Chicago Bridge and Iron, they may yield information, but
13 one of the things that I tell all my clients -- because
14 they will look at a particular transaction that was
15 allowed to proceed, and they will say, "Well, if they can
16 do that, why can't we do this" -- is that every merger is
17 sui generis.

18 And that's one of my concerns about the
19 concentration data, is that they blur the things that
20 make these transactions sui generis.

21 MR. RULE: John, let me just ask you, and
22 really make it clear. There have been some attempts -- I
23 think they have been somewhat feeble -- to look at
24 transactions that were investigated and were allowed to
25 go forward. Typically, those have been above the

1 thresholds. In fact, in all the cases I think they have.

2 And my point is -- and really goes to Steve's
3 -- the predictability in establishing a safe harbor. And
4 it seems to me that, unless you can show that currently
5 that a great mass of transactions that are operating in
6 the safe harbor are having some sort of systemic adverse
7 effect on the economy, you would have to say that at
8 least the current thresholds are okay. But maybe I'm
9 wrong about that.

10 But then you go beyond that to look at the data
11 that you have now, and you basically see that the
12 agencies -- notwithstanding that they are looking at
13 deals that are above certain thresholds -- they have
14 decided to almost never challenge anything below 2,000 or
15 an increase of less than 200.

16 I mean, doesn't that suggest to you, as an
17 economist, that those are then more appropriate safe
18 harbors than what we have now, and that, even though
19 there may be, somewhere down in the bottom, a few adverse
20 deals, that the costs or the benefits of predictability
21 likely outweigh those costs?

22 MR. KWOKA: I think I would agree with that,
23 Rick, at least in terms of the safe harbors and the
24 likely value of raising them. And I think that most of
25 us here probably agree that safe harbors are particularly

1 useful for enforcement and for the private bar in
2 advising clients.

3 Now, I have no quarrel with that, whatsoever.
4 I think that your point is well taken. Larry White and I
5 put together something called the "Antitrust Revolution,"
6 which is a series of case studies. Some of you may have
7 seen this, and every edition that comes out, we always
8 ask our authors of cases that moved from edition to
9 edition to go back and evaluate the consequences of
10 actions taken, or some instances actions not taken as,
11 essentially, retrospectives.

12 These are people familiar with the industry,
13 familiar with the data sources, probably follow this over
14 time. And we have very few instances in which people are
15 in a position to make that evaluation. And these are
16 skilled, informed observers of these particular
17 industries. It's just extraordinarily hard to make
18 meaningful analyses after the fact. And again, it is for
19 the reasons I have said before.

20 I think that is one of the challenges. And as
21 -- rightly points out, the agencies have offered now at
22 least the information necessary to do some of that. And
23 I know that David, is fostering that kind of analysis,
24 both within the agencies and outside. I think that's one
25 of the great areas of research that would be

1 extraordinarily helpful in thinking about the
2 consequences of policy.

3 MR. NEWBORN: To increase the predictability,
4 which seems to be something that everyone seems to agree
5 with now. That's great. Raising the HHI standard in the
6 guidelines doesn't do anything. It's got to be a hard
7 and fast safe harbor. That increases the predictability.

8 And as far as John's point that there may be
9 harmful mergers in the under-1,800 category, I think
10 someone made the point that probably if there were, you
11 would have the customer complaints, you would have the
12 hot documents, and you would have the challenges. The
13 fact that you didn't have them indicates that the vast
14 majority aren't problematic -- although I'm sure there
15 are a few that would be.

16 My point is that if we're going to do anything,
17 in terms of the guidelines, it's got to make the safe
18 harbor a hard and fast safe harbor. I think that would
19 really improve predictability to all of us.

20 It could be 1,800, it could be 2,200. It
21 doesn't matter.

22 MR. SIBLEY: Well, I mean, leaving the number
23 aside, hard and fast, to me, suggests that whatever the
24 number is -- are you saying you ought to remove the
25 current wording, which says -- Greg Werden would know

1 this by heart -- something to the effect that the
2 agencies are unlikely to oppose a merger? Would you like
3 it changed to "will never?"

4 MR. NEWBORN: Yes, yes, that's exactly what I'm
5 talking about.

6 MS. MCDAVID: What do you do, Steve, with an
7 industry with, for example, a history of collusion? I
8 would really love to know what the 1,400 case was.

9 MR. NEWBORN: Well, my feeling about the
10 history of collusion is if you had to collude, then the
11 merger really wasn't particularly relevant; you colluded.
12 And I understand the history of collusion seems to be a
13 big thing.

14 I really am enforcement-minded, even though I'm
15 not sounding that way today. But I really believe that
16 if you had to collude in order to get a higher price,
17 then it's hard for me to believe that the merger is going
18 to do anything, one way or another. I don't see it. I
19 guess you don't have to collude with one more guy, but
20 you're colluding anyway. So what's the merger have to do
21 with it?

22 MR. SIBLEY: Well, see if you can push it a
23 little further in what you would like done to the
24 guidelines. So far, with the exception of perhaps
25 wanting a higher threshold and something to be clarified

1 as a safe harbor, mainly you're saying don't make it
2 worse by adding more half-baked theories until they're
3 fully browned, or something like that?

4 MR. NEWBORN: Yes, I think that's fair.

5 MR. SIBLEY: Now, you know, currently the
6 guideline consists of these numbers, whatever they are,
7 plus a bunch of other stuff you ought to look at. Would
8 you -- if you were revising the guidelines, would you
9 take things off the table? You say there are too many
10 theories, or too many factors right now, proposed as
11 things we ought to consider.

12 MR. NEWBORN: If I were rewriting the
13 guidelines in one administration and it was approved in
14 the next -- if that's your question -- I think I would
15 probably make it far simpler than it is, yes.

16 MR. SIBLEY: Okay, so rough justice but
17 extremely swift justice.

18 MR. NEWBORN: Rough justice is the right way to
19 go.

20 MR. SIBLEY: Okay.

21 PARTICIPANT: There is nothing swift about it.

22 MS. MCDAVID: No.

23 PARTICIPANT: We don't want it to be swift,
24 let's not get carried away.

25 (Laughter.)

1 MR. NEWBORN: The reason it's not swift is
2 because of all the variables that are written into the
3 guidelines. My problem is that there are people who want
4 to change the guidelines in a radical way that don't make
5 it any more predictable; make it far less predictable.

6 MR. SIBLEY: Are any of them in the audience,
7 by chance, who would like to speak up and expose him for
8 the troglodyte he seems to be here?

9 MR. NEWBORN: Thank you.

10 (No response.)

11 MR. SIBLEY: Well, if there are, they're not
12 saying. Okay. Anyway, we have been talking glibly about
13 the relationship between enforcement and market shares
14 and stuff, which might suggest that economists have a
15 trove of knowledge that is fairly precise relating
16 concentration to something like prices or costs or
17 profits we might be interested in.

18 Craig Newmark has written a very readable and
19 enjoyable statement containing more quotes to be refuted
20 than I have ever seen in a single paper in 30 years of
21 being a professional economist.

22 You know, most of us will sort of start a paper
23 by saying, "So and so said such and such," and then you
24 sort of refute it. Well, that's not good enough for
25 Craig. He has five or six pages of so-and-so's saying

1 various things he's going to refute. In any case, Craig,
2 tell us the awful truth.

3 MR. NEWMARK: Well, I'm torn. After listening
4 to three prominent attorneys say negative things about
5 economics, part of me wants to give a wringing defense of
6 my profession. But unfortunately, at least in one stream
7 of literature, I have to support them and agree with
8 them. But nothing is perfect.

9 I want to talk about price-concentration
10 studies. John Kwoka has already talked about how we have
11 relatively little direct empirical evidence on the effect
12 of mergers, and I think we could all agree that we would
13 like to have some empirical evidence. Economists have
14 lots of theories, but the theories don't make sharp
15 predictions. So any number of people said, "What the
16 guidelines do is dependent, in part, on empirical
17 evidence, but we don't have direct empirical evidence."

18 So, what kinds of evidence do we have? Well,
19 there are several types. I'm going to focus on one
20 called price-concentration studies. The idea that if you
21 have a market that's defined locally -- grocery,
22 retailing, most banking products, gasoline retailing --
23 that you go and you track the concentration levels in
24 various local markets, compare them to their prices, and
25 try to get an idea whether concentration is, in fact,

1 associated with price.

2 One of the speakers earlier this morning called
3 it a kind of natural experiment, with concentration
4 varies in different localities, you get an idea of how
5 tightly concentration relates to price.

6 The vast majority of studies that have been
7 done find a positive relationship. As concentration in
8 the local market increases, it's associated with an
9 increase in price. Those studies are important,
10 therefore, for three reasons. Number one, they are used
11 to justify the structural presumption. Why do we care
12 about concentration? Why do we care about market share?
13 Again, leaving aside theories of which we have many.

14 The argument is offered that, "Gee, because we
15 have these price-concentration studies, there is
16 something to our standard story about concentration
17 harming welfare, something to our story about large
18 market share possibly harming welfare."

19 David has recently co-authored a study in which
20 he talked about two kinds of evidence to support the
21 structural presumption. One of the kinds he mentions is
22 price-concentration studies.

23 Second reason is the antitrust agencies -- at
24 least as far as I'm aware, and based on statements I can
25 read -- use these a lot. Michael Whinston at

1 Northwestern says, "They're the most commonly used
2 econometric technique in current merger evaluations."
3 Messrs Baker and Rubinfeld recently wrote that they are
4 the "workhouse empirical methods for antitrust
5 litigation."

6 So, they seem to be popular, they seem to be
7 used at the investigation stage. We do know that
8 something like a price-concentration study played a role
9 in the Staples case.

10 In fact, in much of the public statements the
11 FTC made about Staples, an example very much of the price
12 concentration ilk was proffered. You go to Leesburg,
13 Florida, and you go into the office supply store that's
14 there -- there was only one firm that was there, it was
15 Staples -- and they would charge you \$4.17 for a box of
16 file folders.

17 You go 50 miles away, said the FTC, to Orlando,
18 where there are three office supply superstore firms, and
19 it costs you \$1.95. QED. In fact, it's reliably
20 reported that that very example played a role in Chairman
21 Pitofsky's support for the case. So, the antitrust
22 agencies use them, at least currently.

23 Third, I think they have good growth prospects.
24 We have some sectors of -- at least the retail sector --
25 that are consolidating. Again, grocery retailing,

1 banking. So there are going to be more mergers proposed.
2 And we have enormous strides being made in gathering this
3 price data. We have enormous amounts of price data the
4 firms are now collecting. They're starting to marry that
5 price data to customer loyalty cards and information.

6 So it's an enormous sand box in which
7 econometricians and antitrust people could play. I read
8 an article just recently that Wal-Mart now gets sales
9 data from each of its cash registers all over the world
10 every 15 minutes. So there is enormous amounts of data
11 being generated in a context where mergers are more
12 likely. I think price-concentration studies will
13 continue to be important.

14 Let me preface my criticism by saying many
15 other people have noted weaknesses in these studies. You
16 can find reservations expressed, you can find criticisms
17 expressed. But the point of the 24 quotes that begin my
18 paper is I claim that most of the current criticisms and
19 warnings about these studies are fairly characterized as
20 perfunctory.

21 They're in the vein that these studies might
22 have problems, and we know that they might have problems,
23 but at the end of the day you have got to decide whether
24 you believe them or not, whether you're going to use them
25 or not. And despite the criticisms that are on the

1 record, my impression, I think, is that there is a large
2 number of people who believe that they are useful
3 evidence. They do tell you something about the
4 likelihood of increased problems as concentration and
5 market share rises.

6 At least one key problem, as I see it, with
7 these studies is that there are two types of competition
8 that exist in the economy. And for one type of
9 competition, the price-concentration studies might be
10 very reasonable, although I still would have some
11 problems.

12 I will call the first type of competition Wal-
13 Mart competition. Wal-Mart is currently running ads, at
14 least in my area, where the little cartoon character
15 comes out and says, "Look out below, prices are falling
16 again." This is the kind of competition we economists
17 stress in our early courses. If there is some industry
18 with a couple of firms making a little extra money, what
19 happens? Firms coming piling in, competition breaks out,
20 they drive those prices down and down and down and down
21 to a minimum average cost, and the operative means of
22 competition is through price.

23 But that's a bit of a simplification. It is a
24 simplification that we make so as not to complicate the
25 theory and completely bore the freshman. What we really

1 want to talk about is quality-adjusted price, and then
2 that leads us to a second form of competition, which I
3 will label Starbucks competition.

4 Lots of people can make you a hot cup of
5 coffee. It's not hard. You have lots of choices. You
6 can go into Starbucks and you can get a very nice cup of
7 coffee served by an uncommonly polite young person in a
8 wonderful ambiance and you can pay \$1.85 or more for a
9 cup of coffee. How can they do that?

10 The answer would seem to be that something
11 about the coffee seems to appeal to people. And that's a
12 very important ubiquitous powerful form of competition.
13 Competition through quality, amenities, and services.

14 And if we agree that that's powerful -- and I
15 could demonstrate that some more, but let me just add two
16 other pieces of evidence to support that it's important
17 -- Dennis Mueller, who studied the success of firms over
18 long periods of time, says that if you find a dominant
19 firm in the United States, and possibly his evidence
20 applies elsewhere -- it is not likely to be a firm that
21 is selling at a lower price.

22 The first competition, the Wal-Mart
23 competition, is certainly possible, but Professor Mueller
24 says that by far, the more likely instance is a dominant
25 firm is selling at a higher price a branded product that

1 people think is superior.

2 The second thing I would throw in for those of
3 you in the Washington area, supermarket chain Wegman's is
4 going to open a grocery store at the end of the month
5 near Dulles. That grocery store will have a cappuccino
6 bar, a sushi bar, a patisserie, offer cooking classes,
7 European bread, and a wood-fired brick oven, among other
8 things.

9 Now, maybe around Dupont Circle that's a big
10 yawn. But in most parts of the country, that's a heck of
11 a supermarket. Presumably they're going to charge higher
12 prices in that supermarket, and people will find the
13 bundled services and amenities useful.

14 So, if we accept, for the sake of argument,
15 that this form of competition is important and very
16 intense and very powerful, what problem does that pose
17 for price-concentration studies? It simply poses a
18 problem of interpretation. You can no longer associate
19 the high prices that you might see with high
20 concentration with consumer harm. They might be all
21 paying Starbucks prices and being happy to pay it.

22 In other words, superior firms compete through
23 non-price competition, they concentrate the industry, and
24 yet we see higher prices. So the positive correlation
25 between concentration and prices -- which I know in the

1 Wal-Mart story is competitive harm -- is no longer
2 competitive harm if there is non-price competition.

3 So, the interpretation problem gets very
4 serious. I would add, for those of you who might follow
5 the economics literature on this, we had this problem
6 years back with the profit-concentration literature.
7 There was and is a very tight correlation between profits
8 and concentration, which, once upon a time, was used to
9 justify the structural presumption.

10 We no longer pay attention to that literature
11 because it has the same interpretation of problem.
12 Superior firms tend to earn higher profits, superior
13 firms tend to concentrate the industry. It's not at all
14 clear what that correlation means for consumer welfare.

15 If I have enough time, let me just add one more
16 point. Someone will raise the question, "But that's what
17 we have multiple regression analysis for." Isn't it true
18 that you can control for the non-price characteristics?
19 Well, some of us would say that's what you have multiple
20 regression analysis for.

21 (Laughter.)

22 MR. NEWMARK: Isn't it true that if I say,
23 "Well, gee, there is a lot of non-price competition in
24 this industry," we can add to the regression model some
25 factors that control for that quality?

1 And my answer is, "I don't think so." I offer
2 three brief responses to the notion that this can be
3 statistically controlled for.

4 Response number one: I think it's very
5 difficult to figure out -- at least for an outsider, or
6 even for an insider -- all the various forms of non-price
7 competition. What's going to be important to consumers?

8 Now, people in the antitrust community says,
9 "We can ask them. We can bring them in, we can interview
10 them, and if we don't know, they surely know." Well, I'm
11 not so sure. And even if they do know, it's going to be
12 hard to measure. Two quick examples.

13 In grocery retailing, there is an enormous
14 amount of competition on consumer convenience. Grocery
15 retailing chains are spending enormous amounts of money
16 to try and appeal to people who have got expensive time,
17 to try to make it convenient. What's one of the ways
18 they do that?

19 They do that with store layout. They spend
20 lots of money researching how to lay out the shelves in
21 the store, so as to make it more convenient. It's even
22 important, according to their research, how you arrange
23 the items on particular shelves. And my question is, how
24 you are you going to quantify that? How are you going to
25 quantify, across firms, store layout and stocking on

1 shelves? Maybe somebody is imaginative and can do it; I
2 think it would be hard.

3 The second little incident is an example that
4 applies to Staples. Apparently, according to an article
5 in Fortune magazine recently, up until recently the
6 managers of Staples -- the very top managers of Staples
7 -- did not have a very good understanding of their costs.
8 And if I went to them and asked them, I say, "What drives
9 your costs," apparently they weren't going to be able to
10 tell me -- at least completely accurately.

11 They used to devote a lot of floor space to
12 furniture and computers, and they were very happy with
13 that. They said, "Oh, these things make us high-gross
14 margins." Well, a couple of years back, the vice-
15 president of finance put in a new software program that
16 looked at a variety of factors and their costs, and -- lo
17 and behold -- she discovered -- those file cabinets and
18 those desks and those personal computers really aren't
19 that profitable. By the time you allow for storage and
20 insurance and transportation and damage -- in fact, you
21 probably need more sales help with some of those things --
22 -- they actually weren't that attractive. They now devote
23 more space to legal pads and pens.

24 So, the top management of an otherwise well-run
25 firm did not have a very good handle on the factors that

1 were driving their costs, which tends to make me
2 question, at least, that if I went to them and
3 interviewed them, and said, "What should I have in this
4 equation," that the answers might -- at least in some
5 cases -- not be accurate.

6 A second related point is -- at retail, at
7 least -- a lot of products are jointly demanded and
8 jointly supplied. This has been noted in some of the
9 literature, but at least as far as I'm aware, hasn't been
10 resolved.

11 So, for example, I care something about one of
12 the items in my grocery cart. But what I really care
13 about is the cost of the entire cart, along with the
14 services and amenities that are provided. If I am an
15 airline traveler, I am interested in, for one thing, the
16 number of flights I can get, where they go to, and I
17 care, obviously, about the price I pay on any individual
18 point-to-point trip.

19 That second dimension, where they fly, how
20 often they fly is important. And how does the airline
21 provide it? They provide it with a hub. I also might
22 want a place where I can drink nicely, so they provide
23 that, too, with a frequent flyer bar.

24 And the problem that creates is, therefore, if
25 you view any item or any small number of items in

1 isolation, you don't necessarily pick up the entire
2 economic decision-making that the firm and the consumers
3 are confirming.

4 Those drearily provided items that require
5 cost, somebody has to pay for them. Somebody has to pay
6 the price for the hubs, somebody has to pay the price for
7 all the research that goes into laying out the stores
8 better. And therefore, any individual item or sets of
9 items is going to have trouble reflecting that jointness
10 in supply and demand.

11 But third and last -- and probably the most
12 serious problem -- why can't I put these costs and
13 quality variables in the equation to control for them, is
14 if you do, you once again get an interpretation problem.
15 The firms control things, obviously, that affect their
16 costs and their quality. If I have those on the right-
17 hand side of a regression equation, I am implicitly
18 measuring a price-cost margin. I am implicitly measuring
19 something like profits. That's the problem we had in the
20 old literature, that's the problem why we started doing
21 price concentration studies.

22 You have an interpretational problem.

23 Starbucks coffee, with the cost of their beans,
24 the cost of training those nice young workers, even the
25 cost of their rents, Starbucks earns a higher margin on

1 their costs. We come back to the same problem, though.
2 Why are they earning that higher margin? It's a good
3 argument it's at least possible that they are earning it
4 not through any kind of consumer-harming behavior, but
5 they are earning it because they are competitively
6 superior. They are offering consumers a better product
7 that, even at a higher price, is attractive to them and
8 beneficial to them.

9 So, this problem of non-price competition,
10 which is acknowledged, and it has been recognized, but
11 there is usually a qualification, "Well, if we have got
12 good econometricians, we get good data, we can control
13 for that problem," I am very skeptical of.

14 Therefore, most price-concentration studies
15 that I am aware of have an interpretation problem. They
16 don't offer an good evidence that higher concentration or
17 higher market share is damaging consumers.

18 I will concede my time. Let me just mention
19 briefly at the end, Staples is the leading example of
20 such a case. Staples, there is an extra dimension. In
21 Staples, you have data over time, as well as across
22 cities. So the Staples research potentially offers some
23 gains that is not available to the standard price-
24 concentration study, but I will simply add that there are
25 problems with doing it over time, as well.

1 MR. SIBLEY: Do you want to start off the
2 response?

3 MR. KWOKA: I think Craig's comments really are
4 quite useful. He has made them elsewhere and previously.
5 And I think they're good reminders to the profession
6 about some things that one needs to be mindful of.

7 Real question is what should one conclude from
8 this. I said in my opening remarks -- but I have said it
9 a thousand times -- is that there is no such thing as a
10 perfect empirical study. I once told someone that I
11 could deconstruct any empirical study ever written, there
12 is always something that one has not measured perfectly,
13 or has left out, and I think that one could walk through
14 the 100 price concentration studies and find some
15 limitation on every one of them.

16 The question becomes whether those factors are,
17 on their face, important, or whether what we know of
18 their quantitative importance can account for the effects
19 that we observe.

20 I notice that when he first enumerated the
21 studies, he mentioned -- groceries, gasoline, and
22 banking, I think, were the three you mentioned, Craig --
23 my colleague at Northeastern, Steve Morrison, has co-
24 authored a large number of studies of airlines.

25 Airline studies that they have done typically

1 have examined quality issues -- scheduling convenience,
2 frequent flyer miles -- and has monetized these through
3 very careful modeling of consumer evaluation of some of
4 these attendant, or corollary companions to the seat.

5 To the best of my knowledge, they never
6 monetized the frequent flyer bar, but the question you
7 have to ask is is that quantitatively important enough to
8 refute the proposition that they find? Since I recently
9 taught this, I happen to recall that in May of 1990 in
10 the AER they have an article summarizes part of a larger
11 study that shows that using quality-adjusted prices as
12 the variable, that every increase in the number of
13 effective competitors -- say, moving from five to four --
14 increases price by anywhere from 4 to 12 percent.

15 And that's typical of the quite careful studies
16 that they have done. Once again, you can find
17 limitations of these, it's an unsustainable burden for
18 those limitations, to negate the collective effects of
19 the most carefully done studies -- not the least
20 carefully done, but the most carefully done studies.

21 MR. RULE: I definitely enjoyed Craig's
22 remarks. It plays to something of a pet peeve that I
23 have always had, which is I think that, if you go to the
24 agencies, there is a recognition that HHIs, concentration
25 numbers, in and of themselves, are not all together

1 reliable.

2 But if you have an econometric study of some
3 sort that some economist trots out, there is a tendency
4 -- I think on behalf of the lawyers, because I have
5 always believed that the incentives generally for staff
6 -- I think they want to do the right thing, but all
7 things being equal, they would rather bring a case than
8 not bring a case.

9 So, if somebody can give them a hard and fast
10 number that makes it look like I can predict this is a
11 problem, they will use it. And there is a tendency, if
12 you are a lawyer, you know, gazing at all this Greek on a
13 page, to say, "God, it must be right, because I can't
14 understand it at all." And so, it lends a sort of degree
15 of certainty that is often hard to refute.

16 It has created, although this is good for the
17 economic profession -- it's created sort of this cottage
18 industry for always doing studies. And even though you
19 may think that they are dangerous, and it's a bad idea,
20 it's kind of like the old story about a lawyer who is the
21 only lawyer in town going broke, but as soon as another
22 lawyer moves in, they're both fat and happy.

23 And so, you have got to hire an economist to go
24 out and do your own study so that you can refute why,
25 "Gee, you know, whatever study you're looking at -- DOJ

1 or FTC -- is really not very reliable."

2 But I think it is always important for folks to
3 remind themselves that economics is not really completely
4 a science, it's more of an art, and that ultimately, when
5 agencies make decisions, they have to be careful and they
6 have to understand that inevitably there is some
7 subjectivity and inherently some degree of uncertainty,
8 because they're trying to predict the future, which is,
9 in almost any endeavor, a dangerous one.

10 MR. NEWBORN: I agree with much of what Rick
11 says, but I have got to tell you I disagree with your
12 comment that lawyers look at these studies and they
13 inherently say it must be right.

14 I have got to tell you I think almost every
15 lawyer I have ever met who has been at the Agency -- and
16 I worked there for 20 years -- looked at these studies
17 with an incredible amount of skepticism. If it helps
18 them, they will use it; if it doesn't help them, they
19 will ignore it. And I don't believe they have a lot of
20 faith in those studies. I believe they believe it can be
21 designed to create any result that is wanted by the
22 outside parties, in which I find myself now.

23 And I believe that internal studies are much
24 more fair. They are trying to be fair. They are not
25 trying to get to a particular answer, they are trying to

1 get to the right answer.

2 I don't believe that the staff has much faith
3 in those internal economic studies, either.

4 MR. RULE: This is one of the reasons that, if
5 I had my druthers in most deals, I would never do a
6 study, because it never helps you, it only hurts you.

7 MR. NEWBORN: It almost never helps you.

8 MR. RULE: But you end up often having to do it
9 because you think it's going to be done internally by the
10 staff.

11 MR. NEWBORN: I agree with that 100 percent.

12 MR. RULE: And the problem is for lawyers -- I
13 don't mean to suggest that the lawyers are going to buy
14 whatever the study is, I'm just saying that if there is a
15 study that they can do internally, and their economists
16 are willing to swear by, that basically is a
17 justification for bringing in a case. They will jump on
18 it pretty quickly.

19 MR. NEWBORN: I have got to tell you, Rick, the
20 reasons for bringing a case come down to what the FTC
21 report said they are. They come down to -- the two most
22 important things -- they come down to hot documents and
23 they come down to customer complaints.

24 If you don't have customer complaints, you are
25 almost never going to bring that case. If you have hot

1 documents, you're looking for other ways to bring that
2 case. But you really need the customer complaints. And
3 those industries where you have customers who might be
4 complaining -- other than supermarkets --

5 MR. RULE: Yes.

6 MR. NEWBORN: But let me just say -- and you
7 can respond to that in a second -- I want to say I love
8 that kind of talk, I think that stuff is very
9 interesting, and I think it's very useful for all
10 practitioners to know all those things.

11 But I kind of agree with John, and maybe
12 everybody, that no study can survive a good cross-
13 examination. Just can't do it. It's impossible. There
14 are so many assumptions in the study, and so many other
15 counter-assumptions one could make, whether it's the
16 internal rate of return, or the cost-of-living index, or
17 whatever the heck you're using in that study, there is
18 another one that someone could equally use that's going
19 to change the study in some minor way -- occasionally in
20 some major way.

21 So, I'm not sure about the studies you're
22 referring to. I still believe in Bain, so what am I
23 doing talking here?

24 MR. KWOKA: This is where we should ask David
25 to comment on what value the Division -- or some

1 representative of the FTC may wish to comment on what
2 value you put on the economic studies you receive.

3 MR. SIBLEY: Well, let's see. We have had
4 three complaints filed since I came to the Division. And
5 in fact, at least our witness for one of those cases is
6 here in the room; the other may be, for all I know.

7 One was a coordinated effect story where, there
8 was some talk about market shares and capacity
9 constraints, but a lot of it had to do with a hot
10 document where somebody said to somebody else, "Come on,
11 let's collude." I'm sure that didn't help the merging
12 parties.

13 Another one we had, which we have decided to
14 put in our "win" column, anyway, we did a lot of sort of
15 sophisticated analysis, none of which gave us much of
16 anything.

17 In the end, I think one reason things came out
18 the way we kind of like them, was that we had a bunch of
19 customers saying that they didn't like it for reasons we
20 could sort of understand, but we never actually modeled
21 much. And so I think the other side decided it wasn't
22 going to be officious, government regulators with too
23 much time on their hands getting in the way of progress,
24 it was going to be, "My God, are we going to litigate
25 against our biggest customers?"

1 Then, in the third case that I'm thinking of,
2 there actually is some econometric stuff. Fortunately,
3 the data is very disaggregated. We know tons, even apart
4 from the econometrics, about what was going on. And I
5 have a lot of confidence in the results there.

6 I was going to try to smoke Craig out a little
7 bit more, and I will just give myself a minute or two,
8 and then we will go to what the EU has to say.

9 Suppose that we didn't have any Merger
10 Guidelines, but we did have all this literature that you
11 discussed here, and let's apply the Steve Newborn test,
12 which is you're not going to have anything in the
13 Guidelines which are not fully accepted over at least two
14 administrations by economists, the administrations, and I
15 guess their barbers, or something.

16 MR. NEWBORN: And you have to eat your
17 children; that's part of my --

18 MR. SIBLEY: If that's the test, and I were to
19 say to you, "I, David Sibley, am charged with drafting
20 the world's first merger guidelines," and I want the
21 first sentence to be, "All things equal, increases in
22 concentration are likely to lead to bad things, although
23 I don't know where they do that," would that statement
24 pass the Steve Newborn test, based on your understanding
25 of the literature?

1 MR. NEWMARK: Steve Newborn test, in the sense
2 that that's agreed to?

3 MR. SIBLEY: That's right, and that it's really
4 solid.

5 MR. NEWMARK: Agreed to, theoretically. We
6 have lots of theory that says that. But what I am
7 asserting -- at least for the price-concentration
8 literature; we could get into the other forms of
9 empirical evidence -- that the price-concentration
10 literature does not support that statement. It's just a
11 big question mark.

12 I can't support that statement based on this
13 particular branch of empirical research. There are other
14 forms of empirical research that have been done that
15 antitrust authority people would say supports that
16 statement, too. But I won't comment on those.

17 But I would say based on my impression of
18 price-concentration studies, they don't offer you any
19 evidence. What you see is higher prices. But we don't
20 know that that is a bad thing. It could be a good thing.
21 It could be Starbucks.

22 MR. SIBLEY: Okay. All right. And our last
23 formal presentation is Vincent Verouden, who is going to
24 talk to us about the -- shall I say EU guidelines or EC
25 guidelines?

1 MR. VEROUDEN: Both are fine, I think. We
2 normally say the EU guidelines, yes.

3 MR. SIBLEY: Now, I have actually met a couple
4 of times with folks from the Commission, and sooner or
5 later the word "modalities," whose definition I am unsure
6 of, gets used. I hope you don't say it.

7 (Laughter.)

8 MR. VEROUDEN: I don't think I will.

9 MR. SIBLEY: Thank you.

10 MR. VEROUDEN: I have prepared a few slides. I
11 would like to use these final minutes to talk about the
12 use of concentration and the market shares in the EU
13 merger guidelines.

14 As you may know, actually these guidelines are
15 very recent. We published them about three weeks ago, on
16 the 30th of January, and they are actually part of a
17 wider package. They complement the new EC merger
18 regulation, which was also adopted in January of this
19 year. And actually, both texts will become applicable as
20 of the first of May 2004.

21 A brief word about the background of this
22 merger regulation, because, in fact, as you will see, the
23 market shares and concentration that are in our
24 guidelines are also linked to what is the new substantive
25 standard in our new merger regulation.

1 The background of this new package, the new
2 merger regulation, is that there were a couple of issues.
3 There were, on the substantive side, two issues that kind
4 of influenced the debate in Europe as to the merger
5 control test.

6 As you know -- or as you may know -- this test
7 has always been the so-called dominance test in article
8 two of the merger regulation. And there was some debate
9 as to how this compares to the substantial lessening of
10 competition test that is used in the U.S. Is it the
11 same, or are there differences? The second substantive
12 issue that I will just mention is actually the role of
13 efficiencies in merger analysis.

14 The existing test is whether a merger creates
15 or strengthens a dominant position as a result of which
16 effective competition would be significantly impeded.
17 Now, and the main question here was, what if a merger
18 involves of two significant companies, and together they
19 will have market power, significant market power, but
20 nonetheless they are not, let's say, dominant in the
21 usual meaning of the word -- for example, being the
22 largest company in the market?

23 What if you have a concentrated market and the
24 merger results in only the new number two in the market?
25 Can our existing dominance test still capture, if need

1 be, such cases?

2 Now, there was some uncertainty as to the scope
3 of this test, and to remove this uncertainty which was
4 out there, it was finally decided by the members of the
5 European Union that a rewording of our merger test was
6 appropriate. And it now reads, actually, that a merger
7 must be prohibited when it would "significantly impeded
8 effective competition, in particular, as a result of the
9 creation of a dominant position."

10 So this kind of singles out creation or
11 strengthening of a dominant position as a primary form of
12 competitive harm. But perhaps not the only one. So,
13 this is the test with which we had to work, and for which
14 the guidelines have been written.

15 The guidelines, as I said, complement the
16 change in the test, and set out, of course, the
17 analytical approach that the Commission intends to take
18 in reviewing individual mergers. And the central
19 question is probably familiar to you: Will the merger
20 enhance the level of market power in the market for one
21 or more firms? And increased market power means
22 increased prices or other harm to consumers.

23 The guidelines make the distinction which is
24 also familiar to you, mainly that between unilateral
25 effects and coordinated effects, those are the two main

1 ways in which a merger can cause harm to competition, to
2 consumers.

3 And it is indicated that -- I'm coming now to
4 the test -- unilateral effects may arise, in particular,
5 when the merger leads to a dominant position. This comes
6 a little bit back to the general idea that while -- the
7 larger the companies involved, the higher everything else
8 being equal -- the anti-competitive effects that one
9 could expect to take place in the markets.

10 We have two sets of indicators in our
11 guidelines, market share indicators and indicators based
12 on HHI. Let's start with the first, the market share
13 indicators.

14 Historically, since we always had this
15 dominance test, the research question in any merger
16 investigation was often, "Well, will the new entity have
17 a new dominant position post-merger?" And this leads
18 one, naturally, to look at what is their likely market
19 share, for example, what is their likely market position
20 in the future?

21 And so, a lot of experience has been built and
22 case law has been established on the notion of dominance,
23 and what we have done is to adopt two indications by the
24 court. The first is that when a merger produces a
25 company with more than 50 percent market share post-

1 merger, then this, in itself, could be evidence of the
2 existence of a dominant market position. And this is
3 something that the European Court of Justice has
4 established in a number of cases. It may also be below
5 this 50 percent if other factors are present, as well.

6 The second indicator is that when, the merged
7 entity will have a rather small market share, so to
8 speak, a limited market share, then there is unlikely to
9 be any anti-competitive effect. And according to case
10 law, when the combined market share is less than 25
11 percent, there are unlikely to be problems.

12 The exception is, however, for coordinated
13 effects, where this 25 percent market share indicator
14 does not apply.

15 On HHI -- like I said, with our traditional
16 test, which was the dominance test, we have often focused
17 on only the market share of the companies and their
18 combined market share post-merger. We didn't kind of
19 routinely look at HHI levels in our previous cases.

20 But still, we thought it was useful to have
21 them. And, to get some insight into the levels that were
22 implicitly applied in previous cases, we did a study and
23 we looked at implicit levels in previous cases. And this
24 led us to come up with the following system and levels
25 for the HHI indicators.

1 That is that the commission is unlikely to
2 identify competition concerns when either the HHI is
3 below 1,000 and in such cases it's not even really
4 necessary to do further analysis.

5 For intermediate levels of HHI -- that is,
6 between 1,000 and 2,000, and a delta below 250 -- it is
7 equally unlikely to identify competition concerns. And
8 the third range -- that is, the higher HHI levels above
9 2,000, but where the delta is below 150 -- the merger is
10 also not likely to produce negative effects.

11 So, this structure, in terms of intervals of
12 HHI and then a delta which goes with it is, of course,
13 you know, familiar to you. It's also in the U.S.
14 guidelines, so we took it as an example.

15 Where, however, we decided to take a different
16 approach is that the message that we kind of connect to
17 these levels is different. It follows what we could call
18 a soft safe harbor approach. So it distinguishes it a
19 little bit from the hard and fast safe harbor. It's not
20 hard and fast, but it does give a very decent --
21 hopefully -- indication.

22 A further difference is the following. When we
23 looked at our previous cases, in trying to find a level
24 below which, let's say, there would be no problems from a
25 competition point of view, it was, of course, very

1 difficult to really get such a level, which in a clear
2 and informative way, would separate cases that are
3 unlikely to give problems from other cases.

4 But we also found that quite often there were
5 specific circumstances which meant that actually the HHI,
6 which was present in that case, was not very informative.
7 Now, not very informative, of course, that sounds like a
8 very broad thing. We actually have opted to list the
9 special circumstances in our guidelines.

10 It's not necessarily exhaustive, but it's
11 informative in its own right. And I must say that on
12 this part, we actually followed the merger guidelines
13 which also had a similar approach.

14 Anyway, so we say, "Well, if your HHI levels
15 are below the levels indicated, then you are fine."
16 That's basically the message, except when there are
17 objective or reasonably objective circumstances, and I
18 have listed all six of them here. Some of them are
19 actually quite obvious, and I don't think they are giving
20 rise to much debate, in the sense that -- at least that's
21 what I think -- if a merger involves a recent or
22 potential entrant, then, you know, that's a special case.

23 The same we say may indicate when merging
24 parties are innovators, for example, with pipeline
25 products, or when there are significant cost share

1 holdings between the players in the market.

2 Then we have two which are related to possible
3 coordinated effect scenarios, so that's indications of
4 past collusion. We thought we could single out that one
5 also as a specific circumstance.

6 And the final one, actually, has to do with our
7 test -- I mean still the dominance part of our test --
8 and that is when a party has more than 50 percent market
9 share pre-merger. Well, then, we don't really want to
10 give any indication, in any case, and it's all about
11 looking into the effects of the case themselves.

12 The idea here is simply to actually single out
13 these cases, and by singling them out, it somehow becomes
14 more feasible to get levels of the HHI below which,
15 generally, the Commission is unlikely to find any
16 problems. And so we thought this is informative in its
17 own right, and it proves a little bit, hopefully, the
18 predictability.

19 Of course, it is not certain it will match the
20 Newborn test and so on, but we think it's an informative
21 approach, and one that is hopefully proving valuable in
22 the coming years.

23 One final remark, I think, on the levels
24 themselves. You know, you can always ask yourself, or
25 you can always say there are cases that are above the

1 levels, which obviously don't create problems. So why
2 don't you further increase the levels? Or why don't you
3 increase the levels, let's put it like that.

4 And here, I think we should say that it doesn't
5 really matter that there are many cases above the
6 thresholds that are giving rise to problems. What does
7 matter, really, is whether by increasing the levels you
8 kind of start missing cases that actually do give rise to
9 concerns. So this is the consideration that we have made
10 in putting the levels at the -- at where they are now.
11 Okay, thank you.

12 MR. SIBLEY: Getting close to the end. Any
13 quick comments or questions on --

14 MS. MCDAVID: I am reminded by these fine
15 slides about one of the issues that we really didn't talk
16 about, which is the issue of innovation, and what market
17 share and concentration statistics may tell us about
18 competition to innovate and its importance in all of
19 this.

20 And it's not something we can cover in four
21 minutes, but it certainly is an interesting and important
22 issue, and one that the FTC grappled with recently in the
23 opinion that Chairman Muris wrote back in January.

24 MR. SIBLEY: Well, actually, the two other
25 economists here are much more empirically oriented than I

1 am, but in my dim memory is that people who have tried to
2 relate concentration, however defined, to innovation
3 haven't had much luck. Is that correct?

4 MR. KWOKA: Not much luck. I think that's
5 right. If you're not happy with the relationship between
6 concentration and price, you're definitely not going to
7 like the one between --

8 (Laughter.)

9 MR. NEWBORN: Well, there is another panel
10 tomorrow on them, so we can defer to them.

11 MS. MCDAVID: That's right.

12 MR. SIBLEY: Any other questions for Vincent?

13 (No response.)

14 MR. SIBLEY: Okay. Now, you will notice Greg
15 Werden is here. Greg being in the audience is generally
16 a reliable signal that someone is going to be corrected.

17 (Laughter.)

18 MR. SIBLEY: And in fact, today's lucky winner
19 is Rick Rule. So, Greg, what did Rick do wrong?

20 MR. WERDEN: Well, he should have known better
21 than to talk about history he didn't live through.

22 MR. RULE: That's right. I learned it all from
23 you.

24 MR. WERDEN: Not from me.

25 MR. SIBLEY: This is what you call a coup, by

1 the way.

2 (Laughter.)

3 MS. WERDEN: Turner's guidelines, which took
4 three years to write, were meant to pull back
5 significantly from where the case law was going. And
6 clearly did, in relation to Pabst and Von's, and cases
7 like that, for which Turner was roundly criticized,
8 mostly from within. And interesting for the discussion
9 today, he was criticized even more for creating
10 predictability in enforcement.

11 Staff hated that. They loved the effect of
12 random merger enforcement. They loved the in terrorem
13 effect.

14 (Laughter.)

15 MR. WERDEN: 1982 -- Baxter came to the
16 division on March 1st of 1981, already knowing that a
17 1,000 HHI was the magic number, and basing that, it seems
18 mostly on the kind of studies criticized here, or an
19 earlier generation of those studies, but it wasn't
20 entirely clear.

21 The rest of the numbers in the guidelines he
22 kind of made up as he went along. 1,600 was the higher-
23 up number he had in mind, originally, but that got
24 changed to 1,800 because there was 1,600 in one section
25 of the guidelines and 2,000 in another section, and the

1 FTC came up with the brilliant remark that we should
2 split the difference, and we did. You can't say we
3 didn't take any of their comments.

4 (Laughter.)

5 MR. WERDEN: The 1982 guidelines were meant to
6 be a pull-back from the 1968 guidelines. There very much
7 was a significant difference. There was an effort to
8 compare how the HHI numbers matched up with four-firm
9 concentration ratio numbers, and they showed that,
10 assuming that we really enforce at the levels of the 1982
11 guidelines, and we had really enforced at the levels of
12 the 1968 guidelines, that enforcement was becoming less
13 strict, because that was the thinking of the day, that
14 enforcement was a little too strict.

15 But on the other hand, in 1982, 1983, and 1984,
16 we enforced at the levels of the guidelines. And as you
17 do know from firsthand experience, that changed during
18 the second Reagan administration quite a bit, and that's
19 where we started to depart, in some people's estimation,
20 from what the guidelines say.

21 But that, in fact, isn't true, because the
22 guidelines were revised in 1984 to slightly change the
23 wording associated with the numbers in a very crucial
24 way. It only says these numbers mean something unless we
25 decide that they don't. It says, "Unless all of the

1 other factors listed in the rest of the guidelines lead
2 to the conclusion that the merger really isn't the
3 problem." Well, oftentimes that happens.

4 So, I think that's enough of a history lesson.

5 MR. RULE: I distinctly recall there was an
6 analysis, somebody wrote a paper that compared the 1968
7 guidelines to the 1982. And I don't think there was much
8 of a difference.

9 MR. WERDEN: There are several. Not a huge
10 difference, but a difference and a difference that was on
11 purpose.

12 MR. RULE: But not very significant.

13 MR. WERDEN: Not huge. History is very
14 inaccurately misrepresenting where Baxter was, vis a vis
15 where Shenefield was. They weren't dramatically far
16 apart on merger enforcement. The guidelines weren't
17 dramatically far apart on merger enforcement. The second
18 Reagan administration versus the first Reagan
19 administration, that was huge.

20 MR. SIBLEY: All right. In the zero seconds
21 left, any questions? I'm sure most of these folks
22 wouldn't mind sticking around for a couple of minutes
23 more. Go ahead, Alden.

24 MR. ABBOTT: David, I just wanted to make sure
25 the announcement got out that all the materials from the

1 candidates will be posted on the FTC's website as soon as
2 they're available to us from the authors, and presumably
3 on DOJ's website, as well.

4 MR. SIBLEY: Okay. Anything else? Yes, Eric?

5 MR. GRANNON: What are your concerns about
6 consumer welfare?

7 MR. SIBLEY: Well, it sort of depends on what
8 your priorities are. I guess I will have to be Steve
9 Newborn for a while. He would say that, you know, that
10 taking a swift justice is better than rough justice
11 approach. Consumers are probably well served, because at
12 least efficiency-enhancing mergers will know where they
13 stand, and they won't be held up in deals ruined because
14 of the time it takes to investigate and litigate things.
15 I would say something like that.

16 Admittedly, he wasn't real clear about that.
17 Rick, you're sort of a bright-lines person.

18 MR. RULE: One of the interesting things about,
19 for example, the Trinko case is the notion of, type one
20 and type two errors and that sort of thing.

21 And my sense is that, in order to catch an
22 occasional almost random event that potentially threatens
23 consumer harm, you have to invest a lot in resources in
24 terms of lawyer time and uncertainty about deals, and
25 certain deals not going through at the margin.

1 Then you would say that overall, the impact on
2 consumer welfare of having safe harbors that allow most
3 of what are not going to be problematic deals to go
4 forward, even though you have a few false negatives, is
5 worth it at the end. And I have always felt that, in
6 terms of particularly looking at guidelines, it's
7 important to build in the sort of cost of enforcement in
8 deciding what are appropriate rules.

9 And I think, to some extent, at least
10 subconsciously, that's what we were doing in the 1980s.
11 But again, I think that is more relevant when you're
12 talking about creating safe harbors, as opposed to trying
13 to come up with a precise number that divides legality
14 from illegality.

15 MR. SIBLEY: Well, let me just close with a
16 speculation here. Actually, this bright line debate is
17 really quite interesting. One of the potential downsides
18 of being transparent and having bright lines is that the
19 easier it is for that process to be manipulated.

20 It is possible -- I don't know how likely --
21 that what Greg called the in terrorem policy, which is,
22 "We're kind of random, you never know, we might just say
23 no because we feel like it, or might say yes because it's
24 that kind of day," or whatever, may be in a sort of kind
25 of random but possibly horrifying regime like that, the

1 only mergers that would get through are ones that are so
2 transparently wonderful and good that they can survive
3 all that stuff, and there is certainly no manipulation.

4 Now, I haven't thought through how a
5 transparent process of the sort Rick's probably thinking
6 about could be manipulated in public harm, but I wouldn't
7 rule it out.

8 MR. RULE: Well, the one thing I will say is
9 that, you know, Greg is absolutely right, because I was
10 there for the 1984 guidelines, and those words that came
11 back to be important in, you know, 1985 to 1989 were
12 hard-fought words that myself and Deb Garza, principally,
13 persuaded the AAG to agree to.

14 But the problem was, the staff didn't like it.
15 It's not so much, I don't think, the in terrorem effect,
16 what they always would say is, "Look, we have got to go
17 into court, and we don't want these words coming back to
18 haunt us, and we want an out if we decide there is a
19 problem."

20 MR. SIBLEY: I have heard it already.

21 MR. RULE: Yes, and it's very hard to get
22 around that. And essentially, the reason that you have
23 to do it is you have to say, "Look, we're trying to give
24 people guidance," and you have got to make that trade-
25 off. And to some extent we're tying our hands, but it's

1 worthwhile because we're supposed to be doing the public
2 good. But it's not easy to convince staffs of that.

3 MR. SIBLEY: Okay. One more question, I guess.

4 MR. STARGARD: Maybe I missed the point here,
5 but if we separate the U.S. side and the EU side, Mr.
6 Verouden, your very last comments seem to indicate that
7 at the EU commission you are worried about false
8 negatives. That was basically your very last sentence.
9 "We don't want false negatives."

10 And on the U.S. American side, I hear, "Oh,
11 we're worried about false positives. We don't want to
12 over-enforce it, we want to keep things going." Is there
13 a huge divider here or am I misinterpreting?

14 (No response.)

15 MR. RULE: The one observation I will make, and
16 then Vincent should speak to it -- I think the difference
17 is, with all due respect and humility, the United States
18 has had a lot longer experience with our guidelines. I
19 mean, their guidelines, after all, won't go into effect
20 for a couple of months.

21 And I think if you look at the data that the
22 agencies have provided, given the small number of
23 transactions, for example, that are challenged even
24 within a certain range, like 1,800 to 2,000, and that
25 sort of thing suggest that, you know, to me, why they are

1 as low as they are. Because there is a cost to all those
2 investigations, there is a cost to people, in terms of
3 uncertainty.

4 So, moving it up suggests to me you're not
5 going to miss very many. So the number of false
6 positives would be small. I can say that with some
7 degree of confidence because of what those numbers look
8 like to me.

9 For the Commission, this is sort of new ground,
10 I mean, in a lot of ways it's new ground, because it's
11 not just a new set of guidelines, it's a new kind of
12 theory and approach. And based on that, it's
13 understandable that they would be somewhat cautious and
14 worried that, "Gee, maybe we set the number wrong," both
15 on the downside and the upside.

16 And so, I think what Vincent is saying is he's
17 right. Wherever you set that line, particularly if it's
18 a safe harbor, it means that there are going to be deals
19 above the line that get through.

20 But you know, that doesn't mean that you ought
21 to raise the line -- I think he's right -- because, to
22 some point, when you raise the line too far, you are
23 getting too many false negatives as compared to false
24 positives, and that's kind of a trick of figuring out
25 where that line is.

1 MS. MCDAVID: Well, and you have to come back
2 to the fact that this is not where the decision will
3 actually be made, based on these kinds of numbers and
4 statistics. In the end, it will be a much more rigorous
5 and granular analysis than HHIs would suggest.

6 MR. VEROUDEN: Yes, and in any event I would
7 say that our message is only that below certain levels
8 there are unlikely to be problems. We don't say that, by
9 contrast, if you're above the levels there are likely to
10 be problems.

11 So, in fact, the only kind of mistakes we have
12 to worry about are the false negatives. We don't have
13 these false positives. So that is a difference between
14 the EU and U.S. guidelines, which is simply related with
15 the choice of having a safe harbor approach versus the
16 bright line approach, which is currently still in the
17 U.S. guidelines.

18 MR. RULE: I dare say, though, you will
19 probably still make some false positives along the way.

20 (Laughter.)

21 MR. SIBLEY: All right. Well, thank you very
22 much.

23 (Applause.)

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MONOPSONY

MR. HEYER: Okay, so we're ready to begin. Thank you for attending what I think will be a very interesting session.

One interesting thing to me about having a separate panel on monopsony and mergers is that a number of economists have the view that there really isn't very much difference between monopsony and monopoly. They are the two sides of the transaction, every transaction has a buyer and a seller, and it's the same basic framework that you'd use.

Why special attention to monopsony? Well, there has been a great deal of attention to monopsony, per se, particularly in the agricultural and health care. Two of our panelists are particularly prominent in looking at the agricultural sector.

And there has been discussion of whether the antitrust agencies should be paying more attention than they currently do to mergers that might create greater power on the buying side, rather than just the selling side.

And whether or not one thinks that a different framework needs to be applied to monopsony, it does seem as though there are some interesting questions that are worth considering, and our panelists are going to get

1 into some of them. And if they don't, I will ask, or you
2 can ask, hopefully, after their presentations.

3 For example, it does seem to a casual
4 empiricist that a great deal more cases get brought and
5 serious investigations get conducted that involve market
6 power on the selling side relative to on the buying side.

7 And so, whatever one thinks about whether the
8 same framework is appropriate or not, it does seem an
9 interesting question that a good deal more attention by
10 the agencies seems to have taken place, at least in terms
11 of filed matters, in the monopolization rather than
12 monopsonization area. So we will hear a little bit about
13 that, hopefully.

14 And there are issues that have come up having
15 to do with vertical integration, particularly in the
16 agricultural area. Economists often think that vertical
17 integration among suppliers of complements is a
18 presumptively good thing. There are certain well-known
19 efficiency properties, reducing double-margins, things of
20 that sort, and yet there continues to be concern, perhaps
21 rightly, over some things that have been going on in the
22 agricultural sphere, and a couple of our panelists will
23 talk about that, as well.

24 We're lucky to have three very fine panelists
25 here. Let me briefly introduce them before turning the

1 floor over to them. Bob Taylor is the ALFA Eminent
2 Scholar in Agriculture and Public Policy at the College
3 of Agriculture at Auburn University. He previously held
4 positions teaching at Montana State University, at Texas
5 A&M, and at the University of Illinois.

6 And among his professional activities, he is on
7 the executive board of the American Agricultural
8 Economics Association. He has authored or co-authored
9 five books, and has literally dozens of refereed journal
10 articles. He is going to be talking a bit about some of
11 the issues that have come up in the agricultural area, in
12 particular, and I found his remarks very interesting.

13 Peter Carstensen, I think I first came across
14 Peter's name when reading about the testimony he recently
15 gave before Congress on some competition issues involved
16 in the agricultural area. He is the Young-Bascomb
17 professor of law at the University of Wisconsin Law
18 School. He did his undergraduate work at the University
19 of Wisconsin, has a law degree and a master's degree in
20 economics from Yale.

21 I did not know this, but from 1968 to 1973 he
22 was a trial attorney at the Antitrust Division of the
23 Department of Justice -- prior to even I getting there --
24 and has been a member of the faculty of the University of
25 Wisconsin Law School since 1973. His research activities

1 have focused on antitrust and competition law.

2 He has served as a consultant or expert witness
3 in a number of antitrust proceedings, is currently the
4 chair of a drafting committee for a proposed ABA
5 antitrust section monograph on statutory exemptions from
6 antitrust law, and is a member of that section's newly
7 established task force on antitrust exemptions and
8 immunities.

9 Finally, Marius Schwartz, currently a professor
10 of economics at Georgetown, where he has taught since
11 1983. Marius earned his Ph.D. from UCLA, and before
12 that, was at the London School of Economics. He
13 specializes in industrial organization, competition, and
14 regulation.

15 From September 1998 to April 2000, he served at
16 the Antitrust Division of the United States Department of
17 Justice as the Economics Director of Enforcement and for
18 six months was the Acting Deputy Assistant Attorney
19 General for Economics.

20 During this period, he oversaw the DOJ's
21 economic analysis of numerous matters, including in
22 particular, the challenges to the Aetna Prudential and
23 Cargill Continental mergers that raised the sorts of
24 buyer power concerns we will be discussing today.

25 Prior to that, he was a senior economist at the

1 Council of Economic Advisors, and he has written widely
2 about issues involving, among other things, vertical
3 integration.

4 I think we have arranged to have Bob speak
5 first. And so, let me turn things over to him.

6 MR. TAYLOR: Monopsony has been a problem
7 throughout much of the history of agriculture. Sometimes
8 it's severe, and sometimes it isn't. I am going to start
9 with some very general comments about the food system.
10 It's getting to be a global food system.

11 I suspect that very few of you really have an
12 agricultural background. And these days, when you ask
13 kids where food comes from, they say, "The grocery
14 store," so I take every opportunity to talk a little more
15 about the evolving food system and some concerns I have
16 with it.

17 The last five or 10 years there has been
18 massive consolidation -- horizontally and vertical -- in
19 the global food system. It's unprecedented in the
20 history of agriculture and the history of man. Most of
21 my comments will pertain to the livestock and poultry
22 industries.

23 There are monopsony concerns with other
24 commodities, but there is a lot of blood on the floor in
25 the livestock industry, going back to the late 1800s,

1 when the meat packers -- terminology: packers slaughter
2 and process beef and pork -- the packers had written
3 agreements to collude. In 1920, they were broken up.
4 Before they were broken up, the 5-firm concentration
5 ratio was 40 percent.

6 In 1921, we had the Packers and Stockyard Act,
7 which goes further than antitrust law, and prohibits
8 unfair, deceptive, discriminatory preferential and anti-
9 competitive practices. The FTC was involved then, and
10 again in the 1940s. Since the 1982 merger standards have
11 come out, the C-4 has gone from 35 percent to 85 percent.

12 There are many faces of power. There is
13 nothing new or unique about these. One is from sheer
14 size, which HHI and CR ratios attempt to estimate. Size
15 can influence market prices, or in a vertically
16 integrated system, contract terms, and gives firms
17 economic power to control or influence legislation.

18 Size is a problem in some agricultural markets,
19 but in recent years it's the economic power of ag
20 business to control or influence legislation that is of
21 concern to farmers. We have legislation permitting
22 agricultural cooperatives, which were intended for
23 farmers to get together horizontally to counter the power
24 of giant corporations. It really hasn't worked out,
25 partly because farmers and ranchers are so incredibly

1 independent.

2 In recent years, the giant agricultural
3 cooperatives turned themselves into vertical supply
4 chains, and were not very successful. In addition, they
5 have been co-opted by private corporations cutting deals
6 with the agricultural cooperatives.

7 In the poultry industry that I will talk a
8 little bit more about, attempts by contract growers to
9 form associations have been quickly killed, because the
10 organizers have been instantly put out of business by the
11 integrators.

12 Asymmetric information favoring giant ag
13 business firms over farmers and ranchers, price
14 discrimination, preferential deals, barriers to entry --
15 because agriculture is vertically and horizontally
16 concentrated, you can't look at a barrier just at one
17 level, you've got to look at it in a vertical chain, and
18 with preferential deals, a firm can control entry or
19 exit.

20 Also, increasing control of innovation,
21 elements of a threat system, Agency capture -- not
22 Justice or FTC, but possibly others.

23 (Laughter.)

24 MR. TAYLOR: Agriculture associations, some of
25 them have been captured by large agribusiness firms.

1 Possibly land grant capture. This is a way-
2 oversimplified diagram of the structure of the food
3 system, starting with agricultural inputs at the bottom,
4 then farm and ranch production, and coming all the way up
5 to the food consumer.

6 But between the farm and ranch gate and the
7 final consumer, the grocery store, there has been massive
8 consolidation and integration and a lot of firms have
9 deals with each other. So it's more of a spider web than
10 it is any clean delineation, as this diagram suggests.

11 It's just a general statement. There is
12 probably an evolving balance of power between ag
13 processing and food retailing. And I look at things more
14 in terms of a balance of power than just a number of
15 firms.

16 The growing imbalance of power between food
17 retailing and the food consumer, big imbalance of power
18 between ag processing and farm and ranch production.
19 That's where monopsony power comes in. We have also had
20 tremendous consolidation of agriculture input suppliers
21 -- seed and chemical companies -- so farmers and ranchers
22 feel that they're really squeezed from both sides with
23 monopoly power for ag inputs and with monopsony power in
24 the markets where they sell their commodities.

25 I will talk briefly about the poultry industry,

1 and then I will talk about the cattle industry. They are
2 totally different. And the manifestation of monopoly
3 power differs considerably from one industry to another.

4 All production is under contract, the industry
5 vertically integrated in the 1950s in a matter of a
6 couple of years. The integrator owns the birds and the
7 feed, and they make essentially all of the decisions
8 about the breed, when the chicks are placed. They
9 mandate equipment. The pay system is called a tournament
10 by economists, but when you really dig into it, it's more
11 of a lottery. And it can be a rigged lottery at the whim
12 of the integrator.

13 There have been many efforts for legislating
14 contract reform at the state and the federal level, and
15 essentially all of those have been killed.

16 You become a contract poultry producer by
17 invitation only, which to me is a restriction on economic
18 freedom. Started out the contract producers and the
19 integrators looked out after each other. It was kind of
20 a family deal. But it has evolved to where the contract
21 grower has been squeezed more and more, and down to a
22 poverty level of pay, even though they and their bankers
23 bring over half of the capital to the industry.

24 The integrator specifies contract terms. There
25 is absolutely no negotiation. The grower is forced to

1 accept whatever contract terms the integrator offers, and
2 they change that when they see fit. And there are very
3 few opportunities for a grower to change to another
4 integrator because of the pay system. And the fact that
5 an integrator doesn't have to deliver chicks, means that
6 the growers can instantly be made bankrupt.

7 Economists, as I mentioned, talk about it as a
8 tournament pay system, but it has aspects of a feudal
9 system. And some describe contract poultry production,
10 or contract poultry producers, as serfs. But serfs with
11 a mortgage.

12 In the cattle market, the -- I'm talking about
13 the slaughter cattle, fed cattle -- in the last 15 years
14 they have partially integrated vertically. And in my
15 opinion, they will never fully integrate, for good
16 reason. They have partially integrated with what's
17 become known as captive supplies. Part of these are
18 owned and part contracted.

19 Throughout economics, antitrust economics,
20 industrial organization, we talked about buyers and
21 sellers, and a buyer is a distinct entity from a seller.
22 And in a sense, there is a fence between the buyers and
23 the sellers.

24 In this market, the packer can be both buyer
25 and seller at the same time, because of the contract and

1 supplies. And this makes analysis very, very difficult,
2 because they go back and forth. And it's not just one
3 market, you've got beef packers that have captive
4 supplies that they own or control.

5 They are also out there in the cash market,
6 generally buying but they may decide to sell some cattle.
7 But they are also over in the futures market as both
8 buyers and sellers. And there is a lot of room there for
9 mischief, and for big meat packers to exert power and
10 influence prices.

11 The captive supplies are running about 50
12 percent, about 5 percent through direct ownership, 5
13 percent forward contracts tied to the futures market, and
14 then marketing agreements tied to a cash market price,
15 which dominate captive supplies.

16 These captive supplies vary considerably from
17 week to week. It's also international captive supplies.
18 We're really in a world market. And if you look at CR-3
19 ratios for the major trade, the actual flow of
20 agricultural commodities throughout the world, the CR-3
21 ratios are going to be very, very high, and much higher
22 than CR-3, 4, or 5 ratios just based on domestic
23 production. We don't know much about international
24 captive supplies.

25 This has an effect on incentives. Marketing

1 agreements account for most of the captive supplies. The
2 base price on a typical marketing agreement is tied to
3 the cash price in which the packer is an active
4 participant, primarily as a buyer but every once in a
5 while as a seller.

6 This gives the packer a multiplier incentive to
7 manipulate the market and all of the three major packers
8 have extensive captive supplies like this. If you have
9 one pen of cattle that you own, and you can go out and
10 buy another pen of cattle on the cash market -- it's
11 basically a weekly market -- and you, the packer, expect
12 price to be going down that week, whose cattle are you
13 going to slaughter? You are going to slaughter what you
14 own and wait for price to go down, so you wait to enter
15 the cash market and it affects price.

16 Sweetheart deals for the chosen ones, the
17 chosen packers. Supply response, cash price goes down,
18 also allows them to control entry and exit. And it's not
19 really any one of these factors I have mentioned, but all
20 of them taken together can result in a significant and
21 more than additive effect on a cash market, and it makes
22 analysis very difficult.

23 Before I go to this, eight years ago cattlemen
24 filed suit against Iowa beef packers alleging
25 manipulation of the cash market with captive supplies.

1 Similar suits have been filed against the two other beef
2 packers: ConAgra, now owned largely by Swift, and Excel,
3 owned by Cargill.

4 The case went on trial January 12th, in federal
5 court in Montgomery, Alabama. Plaintiffs took three
6 weeks to present their case. Defense took one week to
7 present their case. It was given to the jury a week ago
8 right about now, and at 12:31 today the jury found Tyson
9 IBP -- Tyson bought IBP -- guilty of manipulating the
10 cash market price.

11 Article in today's New York Times about it,
12 "The Cattle Showdown in Alabama," says some time next
13 week the jury will decide -- they didn't. They did
14 today. And if you're interested, I have the questions
15 the judge gave the jury. There are five questions they
16 had to answer. All 12 jurors had to answer yes on all
17 five questions to find Tyson guilty.

18 Now, I am an economist, not an attorney, but to
19 me, these go far beyond the test of the Packers and
20 Stockyard Act. Really tight requirement, and we will see
21 how that goes out.

22 Now, for this workshop, I was asked to look at,
23 you know, was there any reason for treating monopsony
24 different from monopoly, and no, I don't have any
25 philosophical or theoretical or conceptual reason to

1 think we should treat monopsony any different than we
2 treat monopoly, but the characteristics of buyer power
3 may differ considerably from seller power -- the
4 characteristics or manifestation, however you want to use
5 it -- and may differ considerably from industry to
6 industry, even beef compared to poultry.

7 The issues, the characteristics, the way in
8 which power can be exerted varies considerably. And I
9 think the growing economic power is something that needs
10 to be looked at.

11 I know this probably goes beyond the authority
12 of Justice and the Federal Trade Commission, but it's
13 clear that in the last few years, when farmers and
14 ranchers have tried to get state or federal legislation
15 to balance out power, that it has not happened, probably
16 because of the economic and political power of the giant
17 ag business.

18 I would say the five percent rule can be a
19 problem on the monopsony side because in some industries
20 like farming and ranching, the margins are really, really
21 thin. And without buyer power being exerted, they may be
22 making a small profit. But five percent would take them
23 from a small profit to a huge loss. And so that is a
24 problem.

25 CR-4 and HHI indices are not very predictive,

1 in my opinion, as you go from one agricultural commodity
2 or one market to another.

3 And another issue in agricultural markets -- in
4 the poultry industry, and even with the captive supplies
5 in the beef and pork industry -- is that the buyer can
6 dictate not only price but quantity and force producers,
7 the sellers, into an all or nothing decision, and offer
8 them just enough that they will elect to stay in business
9 rather than go out, and with preferential treatment may
10 not offer enough and force some out.

11 But with quantity and price being dictated by a
12 monopolist, it can be shown that from a social
13 standpoint, the outcome is efficient, unlike the textbook
14 monopsony, which just looks at price. So it can be
15 efficient.

16 Then the problem is one of fairness, not
17 efficiency. And that's what farmers and ranchers
18 worldwide -- the independent ones -- have been alleging
19 for some time, that this is not fair. It's not so much
20 the efficiency side. Thank you.

21 (Applause.)

22 MR. HEYER: Peter is going to talk next.
23 Similar issues, broader prospective?

24 MR. CARSTENSEN: We hope a little broader
25 perspective. We will see. It certainly is an honor to

1 be included in these discussions, and a special privilege
2 to be in a panel with these distinguished scholars.

3 As was mentioned, about 30 years ago I left the
4 Antitrust Division Evaluation section to go and become an
5 academic. On my way out the door, I said, "Hey, guys,
6 ever need any help with any new and novel theories, give
7 me a ring." I guess my number has finally come up after
8 30 years.

9 (Laughter.)

10 MR. CARSTENSEN: Well, just be patient, be
11 patient. My interest in the problems of monopsony and
12 buyer power comes from my interest in agricultural issues
13 and the problems that farmers and ranchers faced in
14 marketing their products, but I have come to see it in a
15 broader context where I think the issues lurk in a number
16 of other situations, even though we have not readily
17 identified those.

18 And certainly in the ag area, and I think in
19 other areas, many, or at least some of the problems can
20 only be addressed through reform of the legal structure
21 that constitutes and governs the markets in which these
22 transactions take place.

23 As Bob's reference to the Packers and
24 Stockyards Act indicates, there is a set of other
25 statutes in agriculture that really need some serious re-

1 thinking and modernization.

2 Bob didn't put the dollar number on what the
3 jury found, but it's a \$1.28 billion verdict that single
4 damage award. I would say the instructions the court
5 gave were Section 2 monopoly instructions, and the
6 questions that were asked were Section 2 questions. So
7 what the heck? I think conform the pleadings to the
8 proof -- and throw in a reasonable attorney's fee.

9 (Laughter.)

10 MR. CARSTENSEN: But I've always been a little
11 bit of a bomb thrower, and those are Alabama juries,
12 after all.

13 Well, I think one of the problems we had, and
14 one I want to kind of focus on a little bit is that anti-
15 trust law lacks at present a kind of robust and fully
16 developed set of economic criteria for determining likely
17 competitive harms that come from increased buyer power.

18 We do have underground observations that are
19 suggestive of the kinds of concerns that ought to be
20 considered. Moreover -- and this is important -- we have
21 commitment both from the previous administration and the
22 present one that they will look seriously at buyer power
23 issues and how to respond to those.

24 What I want to do in the next few minutes is to
25 present some of the ways that I think buyer power issues

1 are different from the general seller side kinds of
2 evaluations, and therefore, to illustrate and to argue
3 for my kind of proposition, we need metrics that measure
4 both power and effects grounded in the economic realities
5 of the buying side of the market, and some of the points
6 that Bob has just made, in terms of both of the markets
7 that he has talked about.

8 So, for me, the metaphor that we often hear
9 that monopsony is a mirror image of monopoly stands in
10 the way of critical thinking about, and thoughtful
11 evaluation of, transactions where there should be a focus
12 on the buying side and the public policies that ought to
13 apply.

14 Now, this doesn't mean we walk away from our
15 standard kinds of concerns with exploitation and
16 exclusion. Those occur on both the buying and the
17 selling side. Most of the effects that are prominent on
18 the buying side also can be found with analogs on the
19 selling side of the market, so it's not like a whole new
20 vocabulary.

21 The analysis of buyer power requires many of
22 the same tools and economic sensitivity to coercion, to
23 exploitation, to efficiency that affect merger analysis.
24 But the particulars of the effects to be measured, what
25 are the likely effects, the more specific typology of

1 those effects, the kinds of market shares that ought to
2 trigger concerns are the one that, I think, need to be
3 turned to fit the buying side of the market. And that's
4 really where I want to turn.

5 Now, I should also acknowledge, as Assistant
6 Attorney General Pate did in October, when we were
7 testifying before the Senate Judiciary Committee, we need
8 a lot more work. We need a lot more serious scholarship,
9 serious research in this area.

10 Turning to, I think, five points that I would
11 make generally, and then turn a little bit more
12 specifically to kinds of Guideline-type statements that I
13 would make, with all due deference to the panel last
14 time, that didn't want any changes made in the
15 Guidelines.

16 First thing is to think about the incentives,
17 the opportunities, and the barriers to exploiting buyer
18 power. And here, I would point particularly to things
19 like auction theory, where what we're told repeatedly is
20 that better collusion on the buying side in auction-type
21 situations is a substantial risk because of the strong
22 incentives to participate in such conspiracies, to
23 exploit sellers, and potential bidders do not have --
24 that is, potential entrants into bidding -- do not have
25 the same capacity to disrupt these kinds of cartels that

1 occurs on the selling side of the market.

2 And here, this central thing is because this is
3 collusion about the price that will be paid, rather than
4 the price that you're going to be charging to sell your
5 products. And I think that's a fundamental point to
6 think about, in terms of how these markets -- these
7 market situations -- differ when you're looking as a
8 seller at a powerful buyer, as opposed to buyers -- in
9 terms of the other way around.

10 That is, the buyer wishing to compete on the
11 buying side of the market has to raise the price to the
12 seller. This raises the buyer's cost of doing business,
13 it makes its downstream products more costly.

14 Now, that means all buyers are going to have a
15 shared interest in keeping the cost of their inputs down,
16 cheating -- which, in this case, involves raising the
17 price you pay for your input -- does not immediately
18 increase either your sales volume or your profits. If
19 anything, it's going to put a squeeze on your profit
20 margin as well, because if you buy more you sell more,
21 and now there is more pressure on the other side.

22 So, there are some implications from that.
23 First of all, with respect to coordinated effects, it
24 means that it's going to be easier to coordinate larger
25 groups of competitors because cheating is more costly and

1 difficult, and because there is more of a shared
2 incentive to engage in this activity.

3 Secondly, and something that Bob was just
4 illustrating for you, even in the absence of tacit
5 collusion, any buyer with any oligopsonistic, or
6 monopsonistic power is going to have an incentive to try
7 to push input prices down, to try to increase the spread
8 between its input and its output market.

9 So, what that means, again, is that there are
10 all kinds of incentives. And again, we said some of
11 those are illustrated in terms of incentives to
12 manipulate. Whenever you're a volume buyer -- in beef,
13 for example, where there are some markets out there in
14 which modest quantities of goods are being transacted
15 which become the marker for all kinds of other goods --
16 I'm going to use that to set the price on your captive
17 supply, my incentives to manipulate, especially as I am
18 buying larger and larger quantities, my customers have
19 more difficulty switching, is an enormous kind of
20 problem.

21 We have an example of this in the cheese
22 industry, where Kraft manipulated the price of cheese in
23 the old Green Bay Cheese exchange, in fact, drove down
24 the price of cheese there, the biggest buyer of cheese,
25 about 30 percent effect on dairy farmers because, in

1 Wisconsin the price of milk is a function of the price of
2 cheese, so that you get that.

3 The second thing, again illustrated by Bob, is
4 an enormous capacity for price discrimination. And here
5 I am indebted to Professor Schwartz's discussions of
6 price -- of switching costs and the difficulty of making
7 changes on the supply side of the market so that it
8 becomes much easier to engage in a variety of
9 discriminatory unilateral practices, and we have seen
10 that in the livestock markets.

11 There is a second area of this problem that I
12 see as a recurring one, and that's what I think of as
13 high volume buyers. And I illustrated that a little bit
14 with cheese and other examples where you can manipulate a
15 public market price for your commodity, which is a low-
16 volume commodity markets. This is true in butter as well
17 as -- and cheese. Those are the two examples that most
18 readily come to my mind, but I'm from Wisconsin and so
19 that would be my natural orientation, I suppose.

20 But there is also the large volume retailer
21 that buys in substantial quantities from the high-volume
22 producer. And here, it seems to me at Toys R Us and
23 other examples, we can see a 20 percent national market
24 share can have -- gives you enormous leverage over your
25 supplier.

1 Think about it this way. You are selling, you
2 need to sell through lots of outlets. Suddenly 20
3 percent of your outlets are going to go away? What are
4 you going to do about that? You're going to start doing
5 whatever that 20 percent tells you to do over a wide
6 range of choices.

7 And so, what we see is volume buyers forcing
8 the prices down in order to get an economic advantage.
9 They exercise their buyer power on the upstream supplier,
10 which may then try to pass it off on to further players
11 up the field.

12 The other thing we see recurrently from
13 Interstate Circuit and through to Toys R Us is the use of
14 that buying power to disadvantage competitors, and
15 sometimes more efficient competitors.

16 So, again, we have these kinds of effects that
17 exist. Another one that I reference here is the spheres
18 of influence, the kind of conduct that we would think of
19 on the buying side -- on the selling side, rather --
20 where you have two goods that are particularly good
21 substitutes for each other, and then you have others that
22 are in the broader market but are not nearly as good
23 substitutes, that kind of cross-elasticity.

24 Well, on the buying side of the market in
25 oligopolistic markets, there is a strong incentive to

1 carve up. You look at poultry, you look at beef, you see
2 where those facilities are located. Everybody tries to
3 get their sphere of influence. When you start looking at
4 the interactions there, you get a variety of
5 opportunities, again, both to discriminate and to create
6 your own little domain where you have significant
7 influence over your suppliers.

8 Another point -- and it's what I illustrated a
9 second ago with the cheese example -- why more of the
10 impacts of monopsony power get reflected up a chain to
11 some more distant point. And again, Bob's diagram of
12 farm to processor to retailer. The retailer puts the
13 screws to Tyson on poultry. Tyson doesn't sit there and
14 eat it, he passes it back to the folks that are raising
15 the chickens on their farms. Put the screws to Tyson as
16 a beef producer, that gets reflected back up the stream.

17 And so, to understand where we're going with
18 some of this stuff in terms of effects, you need to look
19 not just at the most immediate party and can they take
20 it, does this look like just creating more efficient
21 transactions at that transactional point, but how do
22 these things play out up the line, if you're going to
23 have a full analysis of these effects.

24 My final point in terms of the overview
25 situations is -- concerns both allocative and productive

1 efficiency on the buying side. I am -- and I hear this
2 all the time -- there are all these negatives, "Oh, we
3 deny this merger, the world is going to come to an end."
4 Well, I have done enough work on the legal history of
5 antitrust to know that that's been said since 1890, and
6 you know, the world hasn't come to an end yet.

7 So, I am very skeptical of all these mergers
8 that are going to be blocked, and it's going to destroy
9 efficiency. I'm a Maoist on this point. That is, Mao
10 said there were many roads to Socialism; I say there are
11 many roads to efficiency. And if you can't merge, then
12 get there somewhere else if there is a real efficiency to
13 be achieved.

14 So while I am very skeptical that we are losing
15 very much, if anything, but the other part of it is --
16 and part of it comes out of what Bob said -- there is a
17 lot of wealth transfer that goes on here. Moreover,
18 there is some work by Sexton and Zhang which suggests
19 that if there is both buyer power and seller power, even
20 if neither is terribly substantial, combine the two and
21 allocative efficiency harms are enormous, relative to any
22 possible modest efficiency gain. You have got to get
23 very, very substantial efficiency gains before you
24 outweigh the costs to allocative efficiency.

25 Moreover, Bob presumes the problem of wealth

1 transfer is one of fairness. I look at it in terms of
2 market dynamics as creating enormous long-term dynamic
3 costs for the economy. If you drive down the revenue of
4 farming, then fewer and fewer folks want to go into
5 farming. Then you in Washington are going to find
6 Congress is coming up with some enormously bigger bail-
7 out of farmers, in order to put folks back on the land so
8 that we can actually produce the goods.

9 There is an enormous kind of problem, then, of
10 what our incentives are to engage in various kinds of
11 activities as you transfer wealth away from the people
12 that are actually creating the initial wealth, their
13 willingness to produce goods and services efficiently and
14 effectively.

15 What does this mean in terms of our merger
16 guidelines kinds of standards? First of all, I think in
17 terms of market definition, where we have got a public
18 market price, where we have got retailers, we need to
19 take fairly generalized kinds of markets -- cheese. Now,
20 anybody from Wisconsin will tell you it's not "cheese,"
21 you have got to say what kind it is. Is it cheddar? Is
22 it Swiss? Is it Gouda?

23 But cheese, by golly, is the market, toys is
24 the market, look at that in terms of the kinds of
25 leverage that can be created over upstream prices. We're

1 looking at more direct kinds of buying situations where
2 you're actually dealing with the basic inputs themselves.
3 Fairly narrow markets because, again, with this
4 discrimination potential, switching is hard. Switching
5 is difficult, unless you really have lots of other
6 options close at hand.

7 And here, again, I come back to thinking market
8 definition needs to focus a lot on the kind of unilateral
9 effect market analysis when we look at substitutability
10 or switchability between particular outlets, in terms of
11 the analysis of specific transactions.

12 I am going to suggest that we need lower
13 thresholds for when we start taking critical looks at
14 mergers where there is a significant buying side factor,
15 because of the reasons I set forth earlier. That is, the
16 incentives are high, the barriers, the obstacles to
17 achieving that are relatively weak, and that, therefore,
18 we need to be very concerned about combinations that
19 reduce us to less than five or six major firms in a
20 market.

21 We need to take a critical look at that point.
22 And then I think that means an HHI of around 1,600, a
23 concentration change of 150 points or so.

24 Competitive effects analysis, again, remember
25 the location of competitive effects can be remote.

1 Unilateral effects, a merger creating buying power
2 creates incentives to manipulate the markets, incentive
3 to engage in discrimination. Creates capacity of buyers
4 to manipulate public markets.

5 Coordinated effects I have already touched on
6 repeatedly. That is, there are strong incentives to
7 collude, directly less incentive to betray that
8 conspiracy. The buyer may find it attractive to create
9 geographic -- or buyers find it attractive to create
10 geographic spheres of influence which indirectly affects
11 competition.

12 Fourth, it seems to me the defenses of
13 efficiencies are very limited in most of these cases.
14 Entry barriers -- and again, I am indebted to Bob for
15 this -- is very high in most of these markets, very
16 difficult to enter, and that therefore we need to be
17 very, very concerned about even modest increases in
18 concentration.

19 I think antitrust law has long recognized that
20 buyer power creates competitive concerns, just as seller
21 power does. However, for too long, a primary focus,
22 especially in mergers, has been on the selling side.
23 It's time to redress that balance, and this session is a
24 step in that direction.

25 Enforcers, however, need to develop a deeper

1 understanding of the unique characteristics of the buying
2 side of the market. This calls, in my mind, for
3 appropriate metrics. A mindless transposition of seller-
4 side criteria for market shares or competitive effects
5 will only result in an inadequate analysis of buyer power
6 implications of mergers.

7 Mergers that create serious competitive risks
8 in one or more buying markets will be ignored because of
9 the failure to employ appropriate market definitions and
10 competitive effects analysis. It is my hope that the FTC
11 and the Antitrust Division will make more sustained
12 efforts to understand the different aspects of buyer
13 markets and buyer market power. Only with that kind of
14 effort can merger enforcement continue to fulfill its
15 assigned responsibility.

16 (Applause.)

17 MR. HEYER: Our final presenter is Marius, and
18 I am sure there won't be any mindless extrapolation.

19 MR. SCHWARTZ: Thank you for your patience. I
20 know that listening at 4:30 in the afternoon is not the
21 most tantalizing prospect, unless I am mistaken, but I
22 doubt it, so thank you for your interest.

23 One of the questions posed to this panel in the
24 press release was how, if at all, should the agencies
25 assess the creation of buying side market power

1 differently than selling power, and that's the question I
2 am going to address.

3 And by "assess," I mean two things. Should we
4 analyze it differently? For example, should we use
5 different information or different concentration
6 thresholds for deciding that there may be a price
7 increase or a price decrease -- say a "price change" --
8 to be neutral?

9 And secondly, should we employ different
10 criteria when deciding whether to bring a challenge? For
11 example, is a price change as a result of the merger
12 enough to bring a challenge, or do you also need to show
13 that there will be a significant reduction of quantity --
14 the latter being the metric that is more associated with
15 efficiency.

16 Now, during my time at the Antitrust Division
17 and outside, I have heard arguments on both sides of
18 this, that on the one hand, we should be less stringent
19 when challenging buyer market power, and on the other
20 hand, as Professor Carstensen would say, that we should
21 be more stringent.

22 So, my position is going for half a loaf to
23 each side, which means a full loaf to no one, and that's
24 because my position is that I don't know of anything in
25 the economics literature that would justify adopting a

1 differential treatment of buyer versus seller, per se.

2 The reasons that I have heard advanced for
3 adopting a differential treatment, on closer reflection,
4 are either present also in the case of seller power, or
5 reflect some other characteristics of the marketplace,
6 not the buyer/seller distinction, per se.

7 So, let me try to divide these points a little
8 bit, first by taking up arguments that we should have
9 less stringent treatment of buyer power, then turn to
10 arguments that say we should have more stringent
11 treatment. Again, by "buyer power" I mean buyer power as
12 compared to seller power.

13 One question that I have run up against is
14 whether to justify a challenge of a merger, say, must
15 there be harm to consumers? And that sometimes gets in
16 the way of bringing a challenge to a monopsony merger,
17 because you are saying consumers, the end users, may not
18 suffer. And I will come back to this in a second.

19 But the threshold issue is when people say
20 antitrust "protects consumers, not competitors," what
21 they really mean is not consumers, literally. What they
22 -- the way I take that to mean -- is trading partners.
23 So the thrust of the statement is that just because a
24 merger is going to hurt competitors of the merging firms,
25 that's not enough reason to bring a challenge. A merger

1 that's efficient will also harm competitors.

2 So what you're worried about are trading
3 partners. Trading partners could be the buyers or
4 sellers. And to bring that point home, suppose,
5 hypothetically, that you have a group of consumers large
6 enough -- a large enough percent of consumers -- getting
7 together depressing the price and reducing the amount of
8 output that they buy from farmers.

9 Well the result is that economic efficiency
10 decreases, and that's because of the reduction in
11 quantity. So that says that gains to the consumers from
12 the lower price are less than the harm that is imposed on
13 the farmers. Should we let that slide, just because it's
14 the consumers that are gaining at the expense of the
15 farmers? I see no reason why, and nothing in economic
16 theory or economic analysis will give you any reasons for
17 why.

18 So, I think we should be symmetric in our
19 treatment of consumers versus producers, firstly. Second
20 point to make is that most monopsony concerns arise when
21 you have a merger of intermediaries. Not a combination
22 of final consumers, as in my previous example, but a
23 merger of intermediaries.

24 Well, in that case, those intermediaries are
25 acting as buyers for one side of the market and sellers

1 to the other side. In that case, a merger that allows
2 the merged firm to depress price to suppliers, is not
3 likely to benefit consumers, and in fact, is likely to
4 harm them.

5 It's conceivable that there may be no effect on
6 consumers, that the effects will be confined to harming
7 the farmers. That could arise, for example, if the
8 merging firms are perfectly competitive on the output
9 side but enjoy monopsony power on the input side.

10 That was the case that we encountered in the
11 Cargill Continental merger. Cargill and Continental were
12 grain merchants. Grain prices to final users were
13 determined in the world market, so the Department did not
14 allege that the merger would increase these grain prices
15 worldwide. What they did allege is that the merger would
16 allow the merged firms to reduce prices to farmers in
17 selected localities because, on the input side, the
18 markets were more localized.

19 So that's a case where farmers would have lost,
20 consumers would remain unaffected, and yet a challenge
21 would be justified, and in this case, was brought.

22 Outside of this special case, where there is
23 perfect competition on the selling side, you might, in
24 fact, expect -- in fact, you would expect -- that a
25 merger that increases monopsony power will also harm

1 consumers. And the basic reason is if the merged firm is
2 to bring about a lower price for the input only because
3 it's buying less of it, that's going to translate into
4 less output, which can't benefit, and more likely will
5 harm consumers. Okay.

6 So, the quick answer to that one -- that took a
7 rather long time to make that perhaps obvious point, but
8 it comes up a fair bit -- is you shouldn't just care
9 about harm to consumers. Trading partners, okay?

10 Next question is, well, is countervailing power
11 an acceptable defense? So suppose that you have a merger
12 that has actually reduced prices to suppliers. Is it an
13 acceptable defense to argue that the merger, while
14 reducing price, will reduce it towards the competitive
15 level as opposed to below the competitive level? The
16 theory being that there is some pre-existing market power
17 on the seller's side which is keeping the price initially
18 too high, and the merger is correcting that distortion.

19 Well, there are arguments to be made on both
20 sides of this, whether you should accept countervailing
21 power as a defense, and maybe we can talk about it later.
22 But my second point here is whatever position you take on
23 that, on whether you accept countervailing power as a
24 defense, that issue arises equally in the case of buyer
25 mergers as in the case of seller mergers. There is

1 nothing unique about buyer-side mergers to raise that as
2 a possible defense.

3 Next question. Putting aside the
4 countervailing power issue, suppose that initially we
5 have perfectly competitive sellers. The merger, by
6 increasing monopsony power, will depress the price below
7 the competitive level. But it's not predicted to have
8 much of an effect on quantity. And that can come about
9 for at least two reasons. One, the elasticity of supply
10 facing the merged firms may be very low -- at least over
11 the relevant price change -- so you're not going to get
12 much of a quantity reduction.

13 The second means by which it comes about is one
14 that Professor Taylor emphasized, and that is if the
15 nature of the contracting process is richer than simply
16 prices, but encompasses both the price and the quantity,
17 a two-part tariff, or any other such scheme, then what
18 the merger may well do is depress the total revenue
19 that's being paid to the other side without affecting the
20 quantity.

21 So we now have no quantity effect, but a
22 significant revenue reduction. Should we oppose such a
23 merger? That question is sometimes framed as, "Are
24 wealth transfers enough to justify an Antitrust
25 challenge?" Well, again, there are two possible answers

1 to that.

2 One is you may care about efficiency, per se,
3 or about distribution, per se. The second one was the
4 reaction that Professor Carstensen gave, which is in the
5 long run, reducing the wealth to one side of the market
6 may well reduce the resources that go into that sector.
7 So, even if in the foreseeable future you have no
8 quantity effects, in the long run you probably will.

9 Whatever the answer to that, again rather
10 tedious point by now is that the question of whether you
11 require a quantity change in order to bring a challenge
12 could be posed equally well in the case of a seller-side
13 merger as in the case of a buyer-side merger.

14 So, this is part one, and I won't abuse my
15 time. There is no reason to be any less stringent on
16 buying-side mergers than on selling-side mergers. And by
17 buying-side mergers, I mean mergers where the alleged
18 concern is on the buying side of the merging firms.

19 Now let's turn to the second point, which is
20 should the treatment be more stringent in the case of
21 buyer-power mergers? First point I want to make here,
22 which is one that maybe I should have begun with, but I
23 didn't because it may be a little more abstract and I
24 didn't want to turn people off, is that the designation
25 of which party is the buyer and which party is the

1 seller, at least from an economic standpoint, is often
2 arbitrary.

3 Think of any transaction. Who is the buyer,
4 who is the seller? When they're giving things to each
5 other, it's an exchange. So you might say, "Well, okay,
6 fine. The buyer is the one that is giving the cash, or
7 generalized purchasing power, in exchange for a specific
8 commodity."

9 All right. How about the case of a financial
10 intermediary, like a bank or a savings and loan? It's
11 taking deposits, which means it's taking cash now in
12 exchange for cash tomorrow, and on the lending side its
13 giving up cash now in exchange for cash tomorrow. When
14 is it the buyer and when is it the seller? Well, it's
15 arbitrary.

16 However, you can easily see that the merger
17 between two financial intermediaries could cause harm on
18 either side of a transaction. So it's unlikely that the
19 competitive analysis or the thresholds or the decision-
20 making criteria should depend on whether you're calling
21 it a buyer or a seller-side transaction.

22 Now, finally, even in the case where you think
23 that it's obviously the buyer, because he is paying cash,
24 and the other side is giving an object in return, again,
25 a simple reformulation of the transaction can change the

1 identities of the parties.

2 So, for example, if a manufacturer is selling
3 this product to a distributor, he is the seller. If that
4 same manufacturer changes the contract a little bit where
5 he retains title to the goods and just lets the
6 distributor keep a percentage of the sales price, you can
7 now think of it as buying distribution services from the
8 distributor.

9 One would think that a merger between
10 distributors that would increase the distributors' market
11 power is going to have pretty much the same effects on
12 the manufacturer in the first scenario as in the second,
13 okay?

14 So, the point of these examples is to really
15 stress that it's unlikely that the labels "buyers" or
16 "sellers" can possibly form a basis for different
17 treatment. Now, let me just address two or three of the
18 specific examples that have been brought up.

19 One is that the anticompetitive harm from a
20 merger in the case of a buyer-side merger may only be
21 felt several layers away. And I agree with that. An
22 example was given, I believe in your testimony, was that
23 if you have a merger of grocery stores in a concentrated
24 market they may pass the price to manufacturers, who in
25 turn pass the price increase all the way up the chain.

1 Well, that's true, and that -- it does flag an
2 important point, which is antitrust enforcers should not
3 construe the lack of complaints by trading partners at
4 the next level as evidence that there is no problem. I
5 agree with that, because the effects may be passed
6 through.

7 But exactly that same problem can arise when
8 you're dealing with a seller's merger and that's simply
9 going to pass most of the price increase to one level
10 over. So, again, there is nothing to distinguish this
11 issue as being a buyer-side-specific issue.

12 Next point, again, one I agree with. Certain
13 buyer-power abuse is not reached by antitrust. So
14 unfairly low prices to farmers, or paying lower prices to
15 farmers that are selling on a market as opposed to so-
16 called captive farmers that were under long-term
17 contracts, you know, some people might think that's
18 unreasonable. I take no position of that because I don't
19 know these industries.

20 But the simple point is there are practices by
21 sellers that are also out of the reach of the antitrust
22 laws. Charging a monopoly price by a seller, if the
23 monopoly was legitimately acquired and maintained is,
24 again, not unlawful. You may not like it, but it's not a
25 violation of the antitrust laws.

1 Finally, and maybe the most interesting one,
2 the claim that lower market shares can suffice for buyer-
3 power cases than in seller's cases. And there are two
4 possible points. And it has been noted that low market
5 shares at the national level are consistent with the
6 existence of buyer power.

7 And one reason that has been put forth is that
8 buying markets are often much more localized. So just
9 because concentration is low measured on a national
10 scale, that's consistent with having fairly high
11 concentration in properly defined local markets.

12 Absolutely correct. In fact, so correct that
13 exactly the same observation applies on seller side of a
14 merger. That just says you have to be careful about
15 defining the proper geographic and product market. But
16 having done that, I don't see any obvious reasons why
17 there should be a difference in the threshold.

18 One example that Professor Carstensen gave was
19 the case of a bidding, a bid environment, where buyers
20 are bidding for a product they do have incentives to low-
21 ball the price. If I recall, there was a period in the
22 Antitrust Division where 80 percent -- maybe a little
23 less, maybe, but not much -- of our cases involved bid-
24 rigging in the case of roads and other government
25 contracts, where the violation was that people were

1 putting in too high a bid for the services they were
2 selling.

3 So, the fact that we have anticompetitive
4 behavior in auctions possibly more frequently than in
5 other forms of exchange, may say something about the
6 auction process, but it doesn't say anything about buyer
7 versus seller cases, per se.

8 Fine. Not to belabor this, but when scholars
9 such as Professors Carstensen and Taylor and others argue
10 that we need a more stringent treatment of buyer cases, I
11 think that most often -- I would bet -- that it's driven
12 by familiarity with a particular industry or a particular
13 case where there are other things going on that may well
14 say there is a problem at lower concentration levels, or
15 there is a problem even where you might not normally have
16 thought there would be a problem.

17 But if we're going to do our job properly of
18 guiding -- putting antitrust enforcement on a sound
19 footing -- then you have to be very sharp about
20 identifying what those factors are, and framing the
21 distinction in terms of those factors, as opposed to
22 arguing there should be different antitrust treatment
23 based on the label "buyer" or "seller." Thank you.

24 (Applause.)

25 MR. HEYER: Thank you all very much. We don't

1 have very much more time. And so, consistent with anti-
2 trust focus being primarily on the consumer, I wanted to
3 begin by asking if anyone in the audience who has
4 bothered to stay around this long and listen to the
5 remarks had any questions before I ask the panelists if
6 they want to direct any questions to one another. I see
7 a hand. That would be you, Sheldon.

8 MR. KIMMEL: I just wanted to note that the
9 last two speakers, I think, agreed that there is an
10 upward sloping supply curve of farmers, and that if you
11 oppress farmers you are liable to get less output.

12 And therefore, I wanted to ask the first
13 speaker, Professor Taylor, about the contract poultry
14 industry, where he was discussing a very concentrated
15 market that wasn't free, and where the farmers were like
16 serfs. But in fact, the production has pretty much
17 tripled in the last 40 years and that's suggesting that
18 however bad the industry is treating farmers, it's able
19 to lure in lots of new farmers.

20 And so, I am wondering what the problem is
21 there.

22 MR. TAYLOR: The poultry industry and per
23 capita consumption of poultry has been pretty much flat
24 for 10 or 15 years, and the -- when the industry first
25 integrated in the 1950s, the producers did well and there

1 was more sharing and the integrator and the contract
2 producers were pretty much on equal footing, from a power
3 standpoint.

4 But it's really about 10 years ago when the
5 producers started getting squeezed more and more. They
6 got squeezed with mandated equipment upgrades and other
7 large capital outlays.

8 Poultry houses have a 20 to 30-year economic
9 life, and there is no salvage value for them. So once
10 you get in -- and most of them, 95 percent, owe money at
11 a bank, and it costs about three-quarters of one million
12 dollars to have five or six high-tech houses, which would
13 be full-time for one person. So they got into it without
14 fully understanding, you could say, but being deceived
15 that they wouldn't have to upgrade.

16 And just about the time they get a loan paid
17 off, it comes again and it's just recently that
18 information has been coming out on the true returns to
19 contract poultry production. So, moving ahead from here,
20 I don't think you will see a lot of people standing in
21 line to become contract producers.

22 MR. HEYER: Well, let me just ask whether there
23 is agreement among the panelists -- and then, Sheldon, if
24 you want to follow up quickly -- that something like an
25 output test across an appropriate amount of time,

1 perhaps, would be a way of gauging whether the
2 arrangements in the marketplace are efficiency-enhancing
3 versus anticompetitive.

4 Now, there may be wealth effects on the two
5 sides of the transaction, but I'm wondering -- Sheldon
6 seems to be getting largely at the issue of whether
7 looking at the output of the market is a good test for
8 whether it's performing well.

9 MR. SCHWARTZ: Well, in general, if you could
10 properly measure output, that's certainly the place you
11 would want to start. There is the comment that I believe
12 Professor Newmark made earlier, that there is quality-
13 adjusted output, and so on. But certainly as a first
14 approximation, if output, properly defined, increases
15 then something good is happening.

16 MR. CARSTENSEN: But you would also want to
17 consider your time period. That is, you have got a 30-
18 year chicken coop. There is often cost there, and you
19 stay in that business a long time, and you might actually
20 be under enormous pressure to increase your output if
21 you're paid on a per-chicken basis, even if it's chicken
22 feed, because of the structure of the situation.

23 So, I would sure want to make sure I got the
24 right measure of quality, and there are some real
25 interesting questions about the quality of a lot of the

1 livestock and chickens that are coming to the market
2 today. And I want to look at that -- maybe 40, 50, 60
3 years even -- well, that's pushing it too far.

4 (Laughter.)

5 MR. CARSTENSEN: But 20 to 30 years we should
6 get those kinds of big investments, but you just can't
7 switch it. I mean, that's all those chicken coops --

8 MR. KIMMEL: Just a brief follow-up. If you
9 look at the most recent Census of Agriculture, you will
10 see a page on historical statistics, and it will show you
11 that production has tripled from the 1960 census to the
12 most recent census, and that increase had not been
13 slowing down. That's all the data we have.

14 MR. TAYLOR: Per capita consumption is just
15 about flat recently, but let me give my overall
16 subjective impression, and a lot of this is backed up
17 with fact.

18 When the industry first integrated in the
19 1950s, there were tremendous gains in efficiency. They
20 brought a better bird to the market, much more uniform
21 quality, and so forth. The inflation-adjusted price has
22 gone down, but recently that's because feed is cheaper,
23 not because of efficiency gains.

24 The poultry system is highly efficient, in my
25 opinion, and the issue is not efficiency -- and

1 theoretically, I can show that when the integrator is
2 putting producers into an all or nothing decision
3 setting.

4 There is no social welfare loss triangle,
5 though. It is highly efficient, but the integrator is
6 increasingly appropriating returns. And the producer is
7 no longer involved in innovation anyway, and I think it's
8 almost flip-flopped to where now the managers they have
9 out there every week -- and in some cases every day --
10 know less about raising chickens but they are getting
11 orders from up above.

12 So, I think a highly efficient system is
13 evolving to where it's less and less efficient. But it's
14 hard to see that from any industry statistics.

15 MR. HEYER: There was another -- I'm sorry?

16 MR. SAWYER: It seems to me that there are more
17 enforcement actions taken in mergers to sellers than
18 buyers. And I'm wondering if the panel can share their
19 views on why that might be. Is it because there are
20 different standards or there is less buyer concentration
21 in the economy than selling concentration? I'm wondering
22 what you --

23 MR. HEYER: Marius, you want to go first? You
24 thought the treatment should be similar.

25 MR. SCHWARTZ: I knew I shouldn't have said

1 that. That's a good question. First of all, I don't
2 know what the statistics are. It would be nice to know.
3 And assuming the facts are right -- and economists can
4 assume things -- assuming the facts are right, I guess
5 one -- the natural conjecture would be the concentration
6 may be typically higher on the selling side than on the
7 buying side.

8 Exactly why that would be I'm not sure. A
9 simple example that would make the point would be at
10 least in the interface between final consumers and
11 whoever they're buying from, you would expect that the
12 market power would really be on the sell side.

13 So, one factual question would be, suppose you
14 stripped out cases that involve final goods industries.
15 Are the enforcement patterns still as skewed as they
16 appear to be today -- as they would appear to be in the
17 overall sample?

18 If that's true, I guess the next question would
19 be to take a little closer look at concentration levels
20 on both sides. One exercise that I think would be worth
21 doing would be to put the burden on folks that think that
22 we're being -- "we," the Agency; I still think of myself
23 as an alumnus -- that we're being too soft on buyer power
24 would be to come up with some cases where we fail to
25 bring a buyer power case and point us to cases where we

1 brought a seller-side case under similar circumstances.

2 Same concentration, same this, same that. You
3 brought this case, you didn't bring that case. Why?
4 That would maybe let us better see whether the result --
5 the failure to bring more buyer power cases -- is just
6 explained by other factors.

7 MR. CARSTENSEN: I want to chime in on this. I
8 think this is one of the things Professor Schwartz
9 suggested, that there is probably some overlap. If
10 you've got buyer power you're likely to have seller power
11 and so you focus on the seller side.

12 I think one of the things that's obscured the
13 issue is where there has been local concentration on the
14 selling side. There is also a buying effect. I do think
15 that there -- until the Cargill and the Aetna case, there
16 really was a strong ambiguity, at least, about things
17 that were expressly buyer-side cases.

18 And I think that I was there when Joel Klein
19 was beat up out in Iowa by the pitchfork waving farmers.
20 That's when I discovered I really wasn't a populist. And
21 he got the message about buyer-side power, and I think
22 that's part of the place where we saw a significant
23 articulation of something that --

24 MR. SCHWARTZ: Yes.

25 MR. CARSTENSEN: Even so, I see if I am to

1 recognize issues and to examine issues -- and I point to
2 the recent FTC decision Wal-Mart's acquisition down in
3 Puerto Rico, where buyer power issues were raised, they
4 got, in effect, the institutional back of the hand, "Oh,
5 we don't care about it, we have thought about it as much
6 as we think needs to be thought about it, and there is no
7 view there," even though there soon could be, given the
8 quantities that one sells. There seems to me to be some
9 question about local product markets there.

10 Another case where -- in the turkey world,
11 where two turkey companies were -- they could be shipped
12 anywhere. The market share is on the seller side, the
13 customer side, zippo. Prices to the farmers I dealt with
14 in the Midwest suddenly went from \$3 to \$2 for turkeys.
15 And there is an example of where the institutional
16 investigation failed to identify the problem.

17 MR. HEYER: That was the FTC.

18 (Laughter.)

19 MR. CARSTENSEN: I'm sure. But the Justice
20 Department --

21 MR. HEYER: Bob, did you have any remarks? I
22 was going to throw it open to one last question. I know
23 all of you had your hand up.

24 MR. RAMADHANI: I was wondering, given that on
25 the agricultural side we see a number of laws that may

1 protect sellers -- is there a sound economic reason to
2 not allow the agriculture market operate on a free-market
3 basis as we see in other segments of the economy?

4 MR. TAYLOR: That's a tough question. I can't
5 give a simple or a short answer, but I will just take a
6 couple of minutes to say that in some ways food is
7 different. There are food security issues, rather than
8 just opening the market up completely.

9 A fundamental problem, a fundamental economic
10 trade-off, problematic trade-off, is that we want to make
11 sure we have enough food around. That means high stocks.
12 Any time you have high stocks that means low price. So
13 there is that trade-off.

14 Another complicating factor is we now have a
15 farm bill that can best be described as a mess. It is a
16 farm bill written by and for giant ag business to
17 maximize volume with a lot of money, taxpayer money,
18 thrown at farmers. But because of the big volume,
19 consumers pay less for food, so they pay more in taxes
20 and less for food. There are many, many complications
21 there.

22 There is also the issue of preserving some ag
23 land for the future. And if we just let all of the ag
24 land go to strip malls, it's not irreversible, but there
25 is a high cost of bringing that back into agricultural

1 production if we should need it in the future. So there
2 are a lot of problems.

3 Inelastic demands, some of the -- you know, the
4 checklist on things you -- that make price fixing or
5 manipulation profitable, if you go down the checklist
6 many of those are met in the agricultural sector and not
7 in a lot of non-ag sectors.

8 MR. HEYER: Last, Peter, you want to --

9 MR. CARSTENSEN: Just -- well, we move closer
10 to market. What I have been -- need a legal constitution
11 for markets. One of the other peculiarities is that a
12 final decision on what crops to plant is made three
13 months or more before he harvests and finds out what the
14 market price is. There are market-specific things and
15 you need market-specific regulations that facilitate the
16 market -- securities laws, and things like that for other
17 specialized markets.

18 And here I do agree with Professor Schwartz.
19 What's motivating me is a concern for what's going on in
20 particular markets and the kinds of market structures
21 that will be most apt there.

22 I think we could do an awful lot to improve
23 market performance for the benefit of farmers and
24 consumers if we had a better regime that came closer to
25 actually running an actual open, fair, transparent,

1 efficient market, and we're thinking -- a lot of those
2 government subsidies and other distortions that are out
3 there that we tend to ignore.

4 MR. HEYER: Okay. Thank all of you for staying
5 as long as you have. I want to thank our panelists and
6 also announce that tomorrow morning, bright and early at
7 9:00, day two begins in the workshop: Non-price
8 Competition and Innovation. And I will see you all back
9 here then. Thank you.

10 (Applause.)

11 (Whereupon, at 5:10 p.m., the
12 conference was adjourned to be
13 continued at 9:00 a.m. on
14 Wednesday, February 18, 2004.)

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