Federal Trade Commission

MERGER ENFORCEMENT IN THE 1990'S
A CHANGE IN FASHION?

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before the

PRACTISING LAW INSTITUTE
ADVANCED ANTITRUST SEMINAR

Four Seasons
San Francisco, California

January 12, 1990

The views expressed are those of the commissioner and do not necessarily reflect those of the Federal Trade Commission or the other commissioners.

With the beginning of the 1990's, we have a new administration in Washington. What does this augur for antitrust enforcement?[1] Will this administration be different? What can we forecast with particular reference to mergers and acquisitions under Section 7 of the Clayton Act?

I hope today to provide an overall perspective on merger enforcement, to address some common misperceptions along the way and to alert you to a few basic guideposts for maneuvering through the complexities of analyzing these transactions. Merger analysis is highly fact specific, and our experience has demonstrated repeatedly that no amount of prior learning can secure instant insight on whether a given transaction will pass muster under Section 7. What I have to say is not intended to provide easy predictability but rather to help you avoid inefficient and possibly counterproductive detours in your merger travels and, perhaps, to keep you from straying down the wrong path altogether.

This is a good time to make the disclaimer that the views I express today are my own and not necessarily those of the Commission or of any other commissioner. I speak with authority for one of five votes on the Commission, enhanced perhaps by whatever insight close observation of the FTC over a long period might provide.

Let me begin with a somewhat historical perspective. The first change that I have noticed -- and this started to occur even before the last election -- is that people in Washington have stopped wearing Adam Smith ties. You all remember Adam Smith, the eighteenth century Scottish economist who wrote The Wealth of Nations. Smith is often cited for the proposition that the best government is the least government. You also may remember the Adam Smith tie, a regular business necktie adorned, in a neatly spaced pattern, with small profiles of Adam Smith. The Adam Smith tie was for several years a common sight suspended from the necks of much of official Washington. But not recently.

What happened to the Adam Smith tie? Maybe the people who wore the ties grew fatigued of wearing the same tie every day, or perhaps their ties wore out. Or does the departure of the Adam Smith tie from the Washington scene signal a change in philosophy?

I mention the Adam Smith tie not to be facetious or because I have a fixation on fashion. I offer the observation because I think it is genuinely telling about the approach to antitrust enforcement under the new administration. The Adam Smith tie was

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[1] In this speech, I use the term "antitrust laws" to include Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45, not as it is defined in 15 U.S.C. § 12.

a symbol of a message of change, of renewed belief in the "Invisible Hand," of a renewed commitment to market rather than government solutions. The departure from the antitrust scene of Adam Smith ties does not signal an abandonment or rejection of this philosophy. Rather, it marks a change in emphasis, a new message consistent with the same philosophy.

Adam Smith observed in 1776 that "people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in . . . some contrivance to raise prices."[2] His observation remains credible today, and the suspicion he articulated underlies our modern antitrust laws. Free markets and sensible antitrust go hand in hand. Yet over the last few years, a perception has developed in some quarters that antitrust enforcement has been lax. What I see happening now under the new administration is an effort to eradicate that perception. This is a necessary development. This is a welcome development.

The perception of lax enforcement is unfortunate. The focus of the devotees of Adam Smith has been on de-regulation, not nonenforcement. Vigilant antitrust enforcement supports deregulation, to ensure that industries are competitive as they move from detailed economic regulation to conditions of unrestricted entry and competitive pricing.

With the new administration, we have a new Chairman of the Federal Trade Commission. Chairman Steiger has endorsed the law enforcement mandate of the Commission and has announced her goal to "secure public confidence in the Federal Trade Commission as a law enforcement agency."[3] I applaud this goal, and I look forward to working with the Chairman, the other commissioners and the Commission's excellent staff to achieve it.

How this will affect the Commission's merger law enforcement, if at all, will unfold with time. No one has espoused dramatic changes in the way we analyze mergers. It may be that fewer "close" cases will be closed at the staff level and that more "close" cases will result in law enforcement action. Cases that might once have failed to go forward because of a divided Commission might now be authorized. I certainly endorse Chairman Steiger's statement last November that cases "'at the

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[2] A. Smith, <u>The Wealth of Nations</u> 128 (Modern Library 1937).

[3] Remarks of the Honorable Janet D. Steiger, Chairman, Federal Trade Commission, before the 23d Annual New England Antitrust Conference, November 3, 1989, at 2.

margin' . . . require . . . careful scrutiny" and that we "should be wary of too readily curtailing review of mergers."[4]

Critics of federal merger law enforcement have tended to focus on the increasing number of mergers and acquisitions, on the absolute size of merging firms, the alleged paucity of cases brought or on external estimates of market share and concentration data in particular transactions.

Let me give you a few statistics. The number of transactions reported under the Hart-Scott-Rodino notification procedures has increased in the last ten years -- from 861 in 1979 to 2883 in 1989.[5] The dollar value of merger and acquisition activity also has increased. In calendar year 1979, the value of transactions publicly announced was $43.5 billion; the comparable figure for 1988 is $246.9 billion.[6] The number of Hart-Scott-Rodino filings is, of course, not a predictor of merger law enforcement. We do not work on quotas. So, too, the dollar value of a transaction may be unrelated to the competitive effects in the relevant antitrust market.

In view of the perception of nonenforcement, you may be surprised to learn that the absolute number of mergers the Commission has decided to challenge increased between 1979 and 1989. In fiscal year 1979, the Commission authorized four preliminary injunction actions. In 1989, the Commission authorized seven preliminary injunction actions. The "high point" in the last ten years was 1988, when the Commission authorized eleven preliminary injunction actions. Looking back to fiscal year 1980, the Commission authorized only one preliminary injunction suit.

The number of mergers the government challenges always has been minute compared to the total number of transactions reported each year. For example, the four preliminary injunction actions authorized by the Commission in 1979 were .46% of transactions reported; the eleven preliminary injunction actions authorized in 1988 were .40% of transactions reported. Even if the Commission had brought twice as many cases in 1989 (for an all-time high of fourteen), this would have involved fewer than one-half of one per cent of reported transactions.

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[4] Id. at 4.

[5] References to years in connection with merger statistics are to FTC fiscal years, except where otherwise specified.

[6] Mergerstat Review 1988 at 7 (Merrill Lynch/W.T. Grimm & Co.). Grimm reported 2,258 publicly announced transactions for 1988 (63% below the 6,107 transactions announced for 1969) and 2,128 transactions for 1979.

Some of the criticism of our enforcement record apparently stems from a misunderstanding of how we have defined antitrust markets in particular cases and, in light of this, the concentration estimates we have derived. In defining product markets, we seek to identify the smallest group of products for which a collusive price increase would be profitable. The task of product market definition is extremely fact intensive, and the result of this analysis may be counterintuitive.

Concentration levels based on popular notions of appropriate markets may have led to a perception that the antitrust agencies are not following the rules for merger enforcement, that the 1984 Merger Guidelines "as enforced" are somehow different from the Guidelines "as written." Some say that the "safe harbor" established in the Guidelines -- an HHI below 1000 -- has become enlarged, that the government does not act unless the post-acquisition HHI is in the range that the Guidelines identify as "highly concentrated" (above 1800). This perception is demonstrably incorrect, in my opinion, and harmful.

The Commission's 1988 decision in B.F. Goodrich[7] is instructive in this regard. Goodrich is a Section 7 case involving two product markets that were virtually identical for purposes of antitrust analysis, except for the post-acquisition numbers. I should add that I wrote separately, dissenting in part and pointing out the similarities and lack of dissimilarities between the two product markets. The similarity between those markets permits us to focus on the numbers.

The post-acquisition HHIs in the two markets were 1131 (+221) and 1663 (+304); the increase was well over 100 points in each market. Under the Guidelines, both markets fell in the moderately concentrated range, in which a challenge is said to be likely in the absence of other factors showing that anticompetitive effects are not likely. Four commissioners found liability in the market for VCM (vinyl chloride monomer), in which the post-acquisition HHI was higher. Two commissioners also would have found liability in the market for PVC (polyvinyl chloride).

The Goodrich case is interesting for two reasons. First, the majority's finding of liability clearly and recently demonstrates that the Commission is enforcing Section 7 against acquisitions that occur in the moderately concentrated range. I believe that this will continue in the 1990's. At the same time, I expect that, as in the past, some mergers that fall in the highly concentrated range will not be challenged, because, for example, entry is easy.

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[7] B.F. Goodrich Co., 110 F.T.C. 207 (1988).

Second, Goodrich is interesting because of the questions it raises about the significance of concentration data. Two commissioners looked at the numbers and said that the presumption of unlawful effects was "relatively strong" in the market with the higher numbers, where the majority found a violation, and that the presumption was "even weaker" in the other market, where the majority found no violation. These observations implicitly suggest that small differences in concentration correspond closely to significant market power. The approach seems to make the numbers more rather than less important.

The presumptions that the two commissioners inferred from the concentration data -- "relatively strong" and "even weaker" -- do nothing to facilitate merger analysis or to enhance the accuracy of our predictions of competitive effects. Is the presumption of liability in one market "relatively strong" in an absolute sense or only as compared to the "even weaker" presumption in the other market? How would the "relatively strong" presumption when the post-acquisition HHI was 1663 compare with the presumption that applies when the HHI rises 100 points and exceeds 1800? The distinctions are unlikely to be useful because if we have learned anything in recent years, it is that concentration figures do not correspond precisely to market power. The temptation to seek comfort from the apparent certainty of numbers is understandable, but we should be wary of false comforts.

I do not expect this emphasis on relatively minor differences in HHI numbers to persist in the 1990's. Concentration data have no precise predictive value, and no consensus exists on the critical levels of concentration. The thresholds identified in the Guidelines are largely arbitrary. Many people have said that, including Bill Baxter, who, of course, was head of the Antitrust Division in 1982 when the HHI thresholds were established in the Guidelines.[8]

Richard Schmalensee, recently appointed by President Bush to the Council of Economic Advisors, has said that the concentration levels identified in the Guidelines -- post-merger HHI's of 1000 and 1800 -- may not have real economic significance but that a policy to challenge mergers only when the post-acquisition HHI is over 1800 would be undesirable.[9] As Richard Posner said in

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[8] Baxter, "New Merger Guidelines: A Justice Department Perspective," 51 Antitrust L.J. 287, 292 (1982).

[9] Schmalensee, "Horizontal Merger Policy: Problems and Changes," I J. Econ. Perspectives 41, 49-50 (1987).

1976, "it is unclear that there can be 'a' threshold," because concentration interacts with other industry characteristics.[10]

Concentration data and the legal presumptions based on them remain important in Section 7 cases. High concentration may be a necessary although not sufficient condition for the exercise of market power. The HHI thresholds provide a starting point in merger analysis and are useful in providing a degree of predictability at both ends of the spectrum, identifying a "safe harbor" at the low end and, at the other end, the highly concentrated range in which a challenge is more likely. Between the ends of the spectrum, particularly in the moderately concentrated range between 1000 and 1800, we must expand our analysis to attain predictability. Unfortunately, I see no short-cut substitute on the immediate horizon for a careful and intensive exploration of the relevant facts.

Concentration data, of course, cannot be computed until the markets are defined. Product and geographic market definition is a very broad subject on which I do not intend to venture today except to mention one point: economic and antitrust markets are not necessarily one and the same. An economic geographic market comprises the area in which the main forces that determine price interact. Firms similarly affected by conditions of supply and demand are said to be in the same economic market.

The approach to antitrust geographic markets is different. From an antitrust perspective, we seek to define the area in which a small, persistent, collusive price increase would be profitable. Would firms outside the provisionally defined area enter in response to a price increase? How long would entry take? Would the additional supply be competitively significant? If entry would be substantantial and rapid, then the geographic market should be extended to include the outside suppliers. If the supply response would be minor and slow -- perhaps because transportation is very expensive or customers prefer local suppliers who can deliver more often or provide local services -- then collusion within the more confined area may be more profitable.

A misperception that may be less common than in the past is that the Commission is concerned only with absolute or Stiglerian barriers to entry, such as patents or government restrictions on entry. This is too narrow a view. We consider any conditions that will influence how long entry might take -- the longer entry takes, the more likely it is that the exercise of market power will occur.

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[10] R.A. Posner, Antitrust Law: An Economic Perspective 56, 112 (1976).

A corollary to misperception about entry barriers is the perception that the potential competition theory has been abandoned. This is a surprising point of view, because, in a very real sense, all of our Section 7 cases are potential competition cases. The question of potential entry pervades Section 7 review, because substantial anticompetitive effects cannot be sustained when entry can occur quickly to increase output and reduce price. We always ask who could and would compete in the relevant market if an anticompetitive price increase were to occur. Indeed, if I were to emphasize one point above all in your analysis of proposed transactions under Section 7, it would be conditions of entry.

Let me pause and make a few suggestions for presenting your case when you come in to talk to me or to the staff about a merger. Above all, be realistic. It is not useful, for example, to argue that because the Japanese have been so successful in cars and consumer electronics, we should include Japanese firms as potential entrants in southeastern U.S. cement markets. Talk about antitrust not economic markets. OPEC oil production cutbacks may affect domestic prices, but the argument doesn't tell us much about the ability of gasoline wholesalers to collude in a local market.

Support your arguments. One approach that is entertaining but not highly persuasive is what I call the kaleidoscope defense. Often the parties attempt to avoid a Section 7 challenge by arguing that the relevant market has numerous potential entrants or numerous product substitutes. When counsel or their economic consultants use the kaleidoscope defense, they focus on a small group of entrants or products and instantly create a vision of that number multiplied many times over. The resulting images, which they then present to us, are fascinating to watch but elusive. Trying to chase those images down can strain the patience of any antitrust enforcer.

Another misperception concerning the Commission's merger policy is that we will not act when the relevant market is small or when the anticompetitive overlap involves only a small part of the overall transaction. The de minimis situation is always a possibility, but my advice to you is not to count on it.

A variation on this theme is the argument that the anticompetitive effects of a proposed acquisition are outweighed by its procompetitive effects in a second market. Section 7 prohibits anticompetitive mergers and acquisitions in "any line of commerce" and does not offer a tradeoff in liability just because other markets may be competitive. It is always dangerous to speak in absolutes. So instead of saying never, let me suggest that it will be a rare situation in which anticompetitive effects in one market will or should be weighed against neutral or even procompetitive effects in another market.

Another common misperception about the Commission's merger policy concerns efficiencies. The perception seems to be that we presume the existence of efficiencies or that we will leave no door unopened and no stone unturned until we find some. It certainly is true that we look for and are receptive to well-supported efficiency arguments at the pre-complaint stage. This approach to efficiencies is described in the Commission's 1982 Statement on Horizontal Mergers and in the Department's 1984 Merger Guidelines. In most cases, the parties to the transaction do not focus on efficiencies that are relevant to Section 7 analysis or do not support their asserted efficiencies adequately. Although we are receptive to efficiency arguments, experience suggests that they are difficult to document, and they rarely carry the day.

The efficiencies that count in our analysis are those that reduce the cost per unit of output broadly considered and are unlikely to be achieved to the same extent except through the proposed merger. Some asserted efficiencies may reduce overall costs but only as a consequence of reducing output. A reduction in output, of course, may be seen as an anticompetitive effect.

Some asserted efficiencies might be achieved by less anticompetitive means, such as internal expansion, contract or a less anticompetitive merger. Anticipated reductions in corporate overhead, for example, may be credible but may not be merger-specific. A superior technology may be equally available through contract as through merger. Projected savings from the synergies of combining research and development facilities can be very speculative -- sort of a high tech blind date and susceptible to the same errors of prediction.

Absent some degree of integration, the combination of two plants under common ownership does not necessarily achieve efficiencies. Two inefficient plants may well remain inefficient, despite a single owner. Scale economies may relate to the output from a single plant and not to the size of the firm. It could be a different story if the production capabilities of the two plants were to be combined in some cost saving way. Of course, when complementarities are obvious, no horizontal competitive overlap may exist.

Let me spend a final moment on remedies. The likely remedy in a particular case is of interest to the Commission at the prosecutorial stage, because there is no point in bringing a case if there is no remedy. We have been and will continue to be concerned about the effectiveness of the remedies we impose, because of the cost to competition and to consumers when a remedial divestiture is delayed.

In the past, some Commission consent orders have lacked sufficient incentive for the respondent to make a timely divestiture. More recently, we have insisted on provisions in consent agreements to increase these incentives. We require hold separate arrangements to protect the assets to be divested, trusteeship clauses that provide for a forced sale if the acquiring firm does not find a buyer and crown jewel clauses that add assets to the divestiture package to ensure its saleability. These provisions make it more difficult for acquiring firms to divest at their leisure by making it more costly for them to delay. The approach seems to have worked fairly well so far. I think you can expect to see additional innovation in our remedial orders if the problem of delayed divestiture recurs.

Looking forward to the 1990's, what is the fashion forecast for Section 7 enforcement? First of all, I am confident that enforcement decisions will continue to be well-grounded in the law and in the facts. I predict that you will see a greater effort to preserve and enhance the credibility of the Commission as a law enforcement agency. Will the government's law enforcement policy change radically? My advice is to anticipate a healthy level of suspicion in the government's review of proposed transactions, especially at the margin. If you don't see Adam Smith around, keep in mind that the economists who are his modern day successors will continue to play a key role in the process. Finally, remember that lax enforcement is a myth.