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Meeting Before the Commission

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I N D E X

WITNESS:

EXAMINATION

None.

E X H I B I T S

FOR IDENTIFICATION

Commission's:

None.

FEDERAL TRADE COMMISSION

In the Matter of:)
) Docket No.: P951201
HEARINGS ON GLOBAL AND)
INNOVATION-BASED COMPETITION)

Thursday,
November 2, 1995

Federal Trade Commission
Sixth and Pennsylvania Avenues
Room 432
Washington, D.C. 20580

The above-entitled matter came on for hearing,
pursuant to notice, at 9:40 a.m.

SPEAKERS:

ROBERT PITOFISKY
Chairman, Federal Trade Commission

MARY L. AZCUENAGA
Commissioner, Federal Trade Commission

ROSCOE B. STAREK, III
Commissioner, Federal Trade Commission

JANET D. STEIGER
Commissioner, Federal Trade Commission

CHRISTINE A. VARNEY
Commissioner, Federal Trade Commission

SUSAN S. DE SANTI
Director, Policy Planning

DEBRA A. VALENTINE
Deputy Director, Policy Planning

SPEAKERS (Continued):

NORMAN R. AUGUSTINE,
President, Lockheed/Martin Corporation

DONALD HUDLER,
President, Saturn Corporation
Vice President, General Motors Corporation

DAVID PITTS,
Pitts Management Associates

W. DALE COLLINS,
Shearman & Sterling

JAMES EGAN,
Rogers & Wells

ANN JONES,
Blecher & Collins

STEVEN SALOP,
Professor, Georgetown University

PASCUAL GARCIA ALBA,
Commissioner, Federal Competition Commission, Mexico

FRANCINE MATTE,
Senior Deputy Director,
Bureau of Competition Policy, Canada

MARGARET SANDERSON,
Chief, Enforcement Economics Division

P R O C E E D I N G S

1
2 CHAIRMAN PITOFSKY: Good morning, everyone.

3 This morning we begin traveling down a slightly
4 different road in these hearings, and we open up the issue
5 that has perplexed antitrust for what? 80 or 90 years and
6 that is how to treat efficiency claims in defense of a
7 transaction: how to measure them, how to trade them off
8 against anti-competitive effects, and how to treat them
9 generally.

10 And we will have four to five sessions on this
11 subject. I think it's one that needs to be addressed in
12 this set of hearings. And even if we don't solve every
13 aspect of that problem, hopefully we can at least frame the
14 issue and come up with some suggestions.

15 As has been common in these hearings, we start off
16 with presentations by members of the business community; and
17 this morning we have an outstanding trio of people to
18 initiate this part of our hearing.

19 Our first participant is Norman Augustine,
20 President of Lockheed Martin Corporation, a position he has
21 held since the formation of that company in 1995.

22 In 1977, he joined Martin Marietta where he served
23 as Chairman and CEO from 1988 and 1987, respectively, having
24 previously acted as President and Chief Operating Officer.

25 In 1975, Mr. Augustine served as Under Secretary

1 of the Army; and before that, he was Assistant Secretary of
2 the Army.

3 Mr. Augustine has been the recipient of many
4 illustrious awards, including the Distinguished Service
5 Medal, which is the highest civilian decoration awarded by
6 the Department of Defense, an award he has received four
7 times.

8 He has also served on numerous corporate and
9 charitable boards and been a member of the board of trustees
10 of several universities.

11 I should add that, in a review process that I was
12 involved in previously, the Defense Science Board, hearings
13 on defense industry downsizing, Mr. Augustine was, in many
14 ways, one of the most informed and influential witnesses
15 that we heard.

16 And it's a great pleasure to welcome you here
17 again, sir.

18 MR. AUGUSTINE: Mr. Chairman, thank you very much,
19 and members of the Commission.

20 With your permission, I would like to submit my
21 prepared statement for the record and just speak informally
22 this morning.

23 CHAIRMAN PITOFSKY: That would be fine.

24 MR. AUGUSTINE: Thank you.

25 Let me say, first of all, that I'm sincerely

1 pleased to be able to exchange some thoughts with the
2 Commission regarding the topics that you introduced. And
3 those of us in business appreciate the Commission's
4 willingness to take this time to try to improve our process
5 for dealing with antitrust questions.

6 My own experience -- and it's very limited -- but
7 the process has been improved substantially as time went on
8 these past few years. And, particularly, that's true of
9 defense transactions and, in good part, because of the DSB
10 report that you chaired, Mr. Chairman.

11 But the comments that I would make today will be
12 constrained in, really, two regards. One is that I would
13 like to focus mostly on defense transactions, transactions
14 of the defense industry, since that's where most of my
15 experience lies. And, secondly, as will become apparent,
16 I'm sure very quickly, I'm not trained in law. I'm an
17 engineer who somehow descended into management.

18 But my background includes 10 years in the
19 Pentagon and 30 years in business. I have been involved in
20 both buying defense equipment and selling defense equipment
21 and have had the experience these past few years of
22 participating, together with others, including our
23 corporation's general counsel, Frank Menaker, who is with me
24 here today, participating in several rather large
25 transactions that have been addressed with regard to

1 antitrust considerations.

2 The three principal ones would be our combination
3 with General Electric Aerospace, a subsequent one with
4 General Dynamics Space Division, and the third being the
5 merger of Lockheed and Martin Marietta.

6 So I think my principal credential at this point
7 is scar tissue, but I would like to draw on that this
8 morning.

9 I'm sure that every witness that appears before
10 you says that their particular industry is unique. I do
11 believe ours is unique in certain respects. One is that we
12 deal with national security as opposed to simply economic
13 issues. The stakes are very high for maintaining a viable,
14 strong industry in our case. The nation's security can
15 depend on it.

16 Secondly, our industry should never be confused
17 with the free enterprise system. We are part of a
18 monopsony. And in some cases embedded within that monopsony
19 are monopolies. For example, if one wishes to buy a B-2
20 Bomber, there's probably only one place to buy it.

21 And then, finally, the buyer in our industry is
22 what might be called a "power buyer" in the sense that the
23 buyer stipulates the conditions under which competitions are
24 run. In some cases, the contractors are required to specify
25 in advance what their profit would be. And they could be

1 held criminally liable if they exceed that profit.

2 And, finally, that buyer is the only one that I
3 know of that maintains 20,000 auditors to be certain that
4 one complies with the conditions that have been agreed upon.

5 The condition we find ourselves in today that's
6 brought about the particular interest, at least among my
7 colleagues, on antitrust issues stems from the fact that the
8 defense budget in the last seven years has been reduced
9 about 39 percent in real purchasing power. But even of more
10 relevance is the fact that the procurement budget is now
11 down some 71 percent.

12 The most immediate consequence of this has been
13 the loss of over a million jobs in the industry thus far and
14 many more, I'm afraid, yet to go.

15 And this has caused there to be a surplus of
16 corporations, if you will. This was pointed out to us by
17 none other than the Secretary of Defense about four or five
18 years ago, who displayed to many of us who were CEO's in the
19 industry a list of -- showing that there were about two to
20 three times too many companies in the industry compared with
21 what they could afford.

22 And, further, the Defense Department made it very
23 clear that they weren't going to be the referee in terms of
24 helping the industry restructure itself. That would be left
25 to the industry; but the fact that it needed to be

1 restructured was made very clear and, of course, was obvious
2 to most of us as well.

3 As I thought about it, I of course am a believer
4 that six strong competitors is always better than five
5 strong competitors. But on a bit more controversial basis,
6 I believe that two strong competitors is better than four or
7 five weak competitors. And I would prefer that both as a
8 competitor or as a buyer or as a seller.

9 The problem is in our industry that this
10 Commission may have to deal with cases where there can only
11 be one strong competitor, and even that one may not be
12 terribly strong.

13 And, fortunately, that's the anomaly to date; so I
14 don't plan to spend much time on it. But that is a concern
15 we should have.

16 Both Secretary Perry and former Deputy Secretary
17 Deutch have spoken on a number of occasions in support of
18 consolidating our industry.

19 And so we found ourselves, four or five years ago,
20 in a position where our antitrust laws, at least as I
21 understood them, were on somewhat of a collision course with
22 the desires of the Defense Department; and this needed to be
23 worked out. And, in fact, I think it has, to a very large
24 degree, been worked out, in part because of the DSB study
25 and in part by what one might, I guess, call case law as the

1 studies of various proposed mergers have been pursued.

2 I would like to start with three suggestions for
3 the Commission's consideration. And these three relate to
4 administrative practices as opposed to substance. And I'll
5 come to the others later. But I think these are very
6 important.

7 One would be a suggestion that the Commission
8 staff conduct a review of the outcomes of recent cases that
9 have come before you perhaps two years after the fact, to
10 see if the outcomes really were what was desired by the
11 Commission at the time the case was dealt with: Whether the
12 cost savings were, in fact, realized and whether the other
13 benefits were realized. And if they weren't, what are the
14 lessons to be learned?

15 One particular instance occurs to me in the case
16 of the Lockheed-Martin Marietta merger, where the consent
17 agreement required, among other things, that Lockheed and
18 Martin Marietta break the exclusive teaming arrangement it
19 had with a key subsystem supplier, an arrangement that had
20 been in place for many years. And the grounds was that that
21 supplier had a sufficiently unique position that it
22 shouldn't be denied to other potential bidders.

23 As it turned out, that particular supplier also
24 has the ability to be a prime contractor and chose to team
25 with itself and has, thus, denied our company and others the

1 possibility of using this critical subsystem that we had
2 been pursuing for years. And I think that's the kind of
3 thing we should determine whether that was an intended
4 outcome.

5 The second suggestion I would like to raise has to
6 do with the relevant roles of the DoD and the Commission in
7 dealing with defense-related mergers, at least as I would
8 see them.

9 In my mind, the end responsibility for national
10 defense resides with the Defense Department, and that
11 includes ensuring that there is an adequate industrial base,
12 hopefully a competitive industrial base, to support the
13 Defense Department.

14 Thus, I believe that in most cases where you're
15 dealing with a defense matter and the DoD has a strong
16 position, I would hope that that position would be given
17 very heavy weight by the Commission as it reviews the cases
18 at hand.

19 Thirdly, it would be very helpful if it were
20 possible for business people contemplating a transaction to
21 speak with the Commission or the staff in private prior to
22 announcing the proposed transaction to seek general guidance
23 to what areas are not of concern, what areas are of concern,
24 and what areas are uncertain; not in a binding fashion at
25 all but in an advisory fashion.

1 And, as I said, it's important this not be
2 discloseable to the public because the objective would be
3 for people in business to be able to determine what risks
4 they were taking by announcing a transaction. And it might
5 be they would choose not to even announce it if it were
6 apparent that they were likely to have serious antitrust
7 hurdles to pass.

8 Finally, anything that can be done to speed the
9 process would be helpful. It's far improved since my first
10 exposure on a large scale. During the General
11 Electric-Martin Marietta consolidation, General Electric
12 Aerospace, it took 29 days to determine whether the
13 Commission or the Justice Department would handle the case.
14 And once it was determined, the request was so broad that we
15 provided over 500 cases of documentation -- I mean boxes of
16 documentation -- in support of the review.

17 The process has, in fact, been speeded
18 substantially since then; but it still is a concern. And
19 the time between announcing an intended merger and the
20 closing of a large one, in our experience, still borders on
21 six months. And I'm not, obviously, arguing for any
22 superficiality in the reviews that the Commission would
23 conduct; but I would like to share from a business person's
24 standpoint the difficulty of trying to keep organizations
25 operating for six months when you have 170,000 employees who

1 don't know who they work for; they don't know where their
2 pension's coming from; they don't know where they will work;
3 some of them don't even know if they will work. The
4 shareholders don't know whether to hold their stock or to
5 sell their stock. And customers aren't sure, if they award
6 you a contract, who will actually be doing the contract.

7 So anything that can be done to reduce this period
8 of suspended animation is important. The stakes are
9 enormous from the standpoint that once a transaction -- a
10 proposed transaction has become public, once it's announced,
11 our stock prices obviously move.

12 In the case of the General Electric/Martin
13 Marietta one, within hours, the stocks moved markedly. And
14 at the time we finally were told whether or not we would be
15 approved from an antitrust standpoint, the stocks had moved
16 about \$2 billion, probably simply because of the merger --
17 proposed merger of those elements.

18 And had the antitrust decision been unfavorable, I
19 think there's every reason to expect that our stocks would
20 have dropped about \$2 billion over night. And so the stakes
21 are very great when these transactions are announced,
22 obviously, that they have a reasonable chance of being
23 completed.

24 A particular subject of importance in defense
25 transactions and perhaps in others is that combinations are

1 encouraged as a considerable part to reduce cost, to become
2 more efficient, to eliminate duplicative expenditures,
3 whether they be facilities or whatever.

4 In the case of defense, most of those cost savings
5 go to the government and then, ultimately, to the taxpayers.
6 It's hard to state a hard and fast rule, but typically about
7 70 percent of the savings that we generate eventually end up
8 with the government.

9 This is of, I think, particular consequence as the
10 Commission evaluates the benefits from the customer's
11 standpoint. In this case, the "customer" is principally the
12 government. This has been recognized. The DSB report,
13 Defense Science Board report, has a statement, and I'll
14 quote it:

15 "Budget reductions have led to vast overcapacity
16 in the defense industry which can only be eliminated through
17 downsizing and consolidation." And, indeed, those savings
18 are enormous. In the case of our transaction with General
19 Electric, we were able to eliminate 5 million square feet of
20 duplicative or unneeded facilities, saving about \$300
21 million a year.

22 In the case of the General Dynamics transaction,
23 among other things, we had two facilities, each half full,
24 in two different cities, building essentially the same kind
25 of product; and by putting those two facilities into one, we

1 were able to save \$100 million a year.

2 In the case of the Lockheed-Martin Marietta
3 merger, which is -- what I'm about to say, the savings are
4 not fully realized; but I have every confidence they will be
5 -- we will close about 8 million square feet of facilities
6 and save about \$1.8 billion a year.

7 Now if one adds this all together, one comes up
8 with a number of well over \$2 billion a year of savings.
9 And I'm sure you're familiar with the Base Realignment
10 Commission process, the BRAC process, which has received so
11 much attention, become a major political issue. Sort of
12 unnoticed, Lockheed-Martin has saved the government about
13 the same amount of money that it will save through this
14 entire BRAC process it just went through. So the savings
15 are significant.

16 In our case, Lockheed-Martin -- well, in fact, in
17 each case but particularly the Lockheed-Martin Marietta one
18 -- the savings have been substantially greater than we
19 originally projected. It was our effort to under promise
20 and over produce, if you will.

21 The difficulty, of course, is: How does the
22 Commission determine whether the savings are real?

23 And from the industry standpoint, our attorneys
24 advise us that we should not exchange, prior to having
25 antitrust approval, detailed cost and pricing data with our

1 proposed partner. And without having that data, one doesn't
2 know exactly how you will restructure the company so that
3 you can determine the savings on which the antitrust
4 approval may hinge. And so one finds oneself in somewhat of
5 a circular circumstance.

6 The ability to make general estimates is certainly
7 present. And I would suggest that one thing that industry
8 might do to assist the Commission in this regard -- and we
9 were, in fact, able to do in the transactions that I have
10 described -- is to arrange the pay back to the government
11 such that the corporations involved float the investment
12 cost, at least to the savings, and then be repaid out of the
13 actual savings as they're realized. So if there are no
14 savings, the companies don't get paid back. That way the
15 government takes zero risk. It shares in the benefits but
16 not in the risk that the benefits may not be realized.

17 I'd like to make a brief remark about a side
18 benefit which concerns competitiveness in the global market.
19 Today in our company we have more than 20,000 jobs here in
20 the United States that depend on our ability to sell abroad.

21 We typically compete with companies that are
22 backed by their governments, sometimes refuse -- sometimes
23 receive something called a cash infusion from their
24 governments and that often own a bank.

25 This is a very tough environment in which to

1 compete; and it would be my suggestion that, as the
2 Commission conducts reviews, that it pay particular
3 attention not only to the fact that there are global
4 competitors available but the fact that these competitors
5 often are governments or government supported and that that
6 has a very powerful and, unfortunately, very distorting
7 impact on the marketplace.

8 I would like to say a word about the fact that in
9 our industry there is a great deal of consolidation going on
10 among our competitors outside of the United States.

11 In some ways, in Europe, they were about 20 years
12 ahead of us in consolidating; and most countries in Europe
13 have gotten to the point they now have only a single
14 contractor in most markets in which we compete. And now,
15 the next step will be to do cross-border mergers in Europe;
16 although, those are proving to be, understandably, very
17 difficult.

18 Nonetheless, as those proceed, U.S. companies will
19 find the competition increasingly challenging. One of the
20 ways that U.S. companies in defense and other industries can
21 become more competitive is through sharing research,
22 cost-sharing research projects, in sharing talent. This
23 reduces duplication; it increases critical mass of talent;
24 improves efficiency.

25 In my judgment, this can be done in most cases

1 without harming competition as long as competition is
2 maintained for the end product that's to be sold. And
3 that's a particularly important condition that I would
4 apply.

5 But I would hope the Commission would make it
6 possible for joint research projects to be undertaken. I
7 understand that under the current law that if one notifies
8 the government of a venture of this type and it's later
9 challenged, as long as the government has been notified in
10 advance that the corporations involved would not be
11 subjected to treble damages, only to single damages. But
12 that's not terribly comforting to companies that are trying
13 to obey the laws in the first place.

14 Well, that summarizes my remarks. There's a good
15 deal more detail in the prepared -- or in the formal
16 statement, Mr. Chairman and Commissioners.

17 Again, let me say that I appreciate the fact
18 you're willing to take the time to hear an industry
19 perspective of these issues, and I would be more than happy
20 to answer any questions you might have.

21 CHAIRMAN PITOFISKY: Thank you very much.

22 Let me start. I would like to focus on the R&D
23 aspect of the defense industry.

24 The defense industry is unusual but not unique in
25 the sense that there was a vast overcapacity and it's an

1 industry that is in the process of downsizing and should be.
2 And we heard your remarks about when people get laid off
3 that that will lead to efficiency, there are redundancies
4 eliminated.

5 But I wonder if you would say a little bit more
6 about your own experience at Lockheed-Martin and what you
7 know about the rest of the industry, has this downsizing led
8 to an equivalent downsizing in the research effort?

9 MR. AUGUSTINE: Mr. Chairman, I would say that the
10 answer is yes. Unfortunately there has been a downsizing of
11 the research effort because there is just less market to
12 support that research effort.

13 That's not been unique to companies in defense;
14 but all the companies that I have reviewed -- and I reviewed
15 a number of them in terms of publicly available data -- most
16 of the major corporations, as they have downsized, have,
17 unfortunately, had to cut back on research.

18 And this is particularly troublesome because our
19 universities are under greater pressure to cut back on the
20 research they do. And, of course, you know the debate
21 that's raging as to the government's research budget.

22 But the one piece of relative encouragement I
23 could offer is that it, at least in our case, and I think in
24 many others, we have cut research back far less than we have
25 reduced most other things.

1 And as we have dealt with these consolidations,
2 some changes are easy to make. For example, when you put
3 two companies together with two headquarters, you only need
4 one headquarters. And that's easy.

5 But when you put two research projects together,
6 we have gone through to look for duplications. And we found
7 that if it's two companies in the same industry -- which, in
8 our case, is the kind of mergers we have had -- there's a
9 lot of underlying research that both companies or all the
10 parties have to share. In our industry, everybody works on
11 stealth; everybody works on numerical aerodynamics;
12 everybody works on advanced composites. It's kind of the
13 entry price.

14 And so if you bring two companies together, you
15 can eliminate much of the work that one of them has done in
16 those areas.

17 But as one moves on into some areas that are a
18 little more unusual, little more risky, more speculative,
19 those are the areas that we find it hard to gain
20 efficiencies without actually just reducing the magnitude of
21 the effort.

22 So the bottom line is that, yes, we are reducing
23 that effort.

24 CHAIRMAN PITOFSKY: A follow-up question, because
25 I agree with you that if the production and the marketing

1 and the bidding is separate, that collaborative research is
2 not nearly the threat that it would otherwise be.

3 In the process of this downsizing, does it appear
4 to you that there's more collaborative R&D? The same
5 amount? Less?

6 MR. AUGUSTINE: I think more.

7 Let's see. I need to be sure I understood your
8 question.

9 You mean collaborative between separate companies
10 or between the companies that came together?

11 CHAIRMAN PITOFSKY: Separate companies.

12 MR. AUGUSTINE: In our industry, in terms of
13 research, there is relatively little collaborative R&D done.

14 I happen to know a little bit about the
15 semiconductor industry because of a study I chaired for the
16 government some years ago. And partly as a result of that
17 study, Sematech was formed, which does do a lot of
18 collaborative research, I think very good research.

19 There's some done in the software industry.

20 But there is still not a great deal of
21 collaborative research done today as compared with the total
22 volume.

23 COMMISSIONER AZCUENAGA: I was interested in
24 something you said about giving the views of the Defense
25 Department great weight in our analysis of mergers under

1 Section 7 of the Clayton Act, and I tend to agree with that.

2 I'm interested to know whether you have given any
3 thought to or have any views on exactly how they should
4 state that. For example, should we insist that the
5 Secretary of Defense say that failure to approve the merger
6 presents a national security risk? Or should we accept some
7 sort of lesser view from -- or should we wait for some sort
8 of lesser statement of risk from the Defense Department?

9 That has been an issue that's been raised and
10 discussed, and I'm interested in your view.

11 MR. AUGUSTINE: I have thought about that some.

12 And, first of all, I think that in major
13 transactions it's not inappropriate to expect the Secretary
14 of Defense to take a position as to the impact on defense.
15 And whether the Secretary should be required to say that
16 failure of the transaction would pose a grave threat, I
17 suspect that's asking too much.

18 But certainly the Secretary should provide a
19 qualitative assessment of what the impact would be on our
20 ability to provide for the nation's defense.

21 But before that, I would hope there could be a
22 good deal of informal iterative conversation at the staff
23 level between the Commission staff and the Defense
24 Department staff to help arrive at a joint view of the
25 importance, or lack of importance, of whatever transaction

1 is proposed.

2 COMMISSIONER AZCUENAGA: Perhaps I've been in
3 government too long, but another question that comes to mind
4 is: Are there particular people in the Defense Department
5 we should pay greater attention to than others?

6 Because it is possible that on this informal basis
7 some people would say: Well, I understand what you mean
8 about competitive concerns, and I don't think there's a risk
9 here. And other people, perhaps at the same level in the
10 hierarchy, would be quite concerned.

11 Can you give us any practical advice about how to
12 sort through that?

13 MR. AUGUSTINE: Well, I'll surely try.

14 I think, of course in the end, the Secretary of
15 Defense is the person who has to, you suggest, obviously,
16 come down as to where the Defense Department stands.

17 But in the spirit of your question, I think that
18 the focal point has to be the Under Secretary of Defense for
19 Acquisition whose responsibility it really is to procure
20 equipment for the military and in whose office those who are
21 responsible for helping to assure a strong industrial base
22 reside.

23 There are several suborganizations within that
24 Under Secretary of Defense for Acquisition's office that
25 your staff would obviously want to deal with.

1 That, though, falls short of getting the views of
2 the military operators in the field who have the
3 responsibility to conduct combat. And those individuals'
4 views should, obviously, be given great weight. The
5 difficulty is that most of them, by character of their
6 experience, have very little background in industrial
7 matters or industrial base or even procurement.

8 And so I think -- or I would hope that the Under
9 Secretary of Defense for Acquisition and his staff would see
10 fit to ask such people, as members of the Joint Chiefs of
11 Staff, for their views on, for example, what will be the
12 importance of having a submarine production capability in
13 the years ahead? And get those views.

14 But in the end, I think the Under Secretary of
15 Defense for Acquisition would be the principal point.

16 COMMISSIONER AZCUENAGA: Thank you.

17 COMMISSIONER VARNEY: I largely agree with your
18 three recommendations, and I had a question on your first
19 one, that we ought to be studying outcomes to see if our
20 assumptions have been borne out.

21 As you know -- or you may know -- in some
22 countries, indeed, some scholarly discussion has occurred
23 about whether or not we should give provisional approval
24 when companies come in and present to us all of the
25 wonderful things that are going to happen in terms of

1 efficiency and R&D and, indeed, global competitors and
2 global markets, what's going to happen on the good side of
3 the ledger sheet if we let a transaction go through.

4 What do you think about us provisionally approving
5 transactions and coming back and looking at them in two
6 years and seeing if the predictions have been borne out?

7 MR. AUGUSTINE: I could surely understand the
8 advantage and the motivation to try to do that, because I
9 suspect there are those who view the world with rose-colored
10 glasses when they're making a proposal and make promises
11 that are going to be difficult to achieve.

12 But from where I sit, I suspect it's not practical
13 to do that. And to give you an example -- to come back two
14 years later and learn lessons to apply to future cases, as I
15 said, I'm very much in favor of; but to come back and to try
16 to unwind a transaction -- this is a poor analogy -- but
17 it's like trying to get the worms back in the can. It's
18 just very hard to do.

19 If you take Lockheed-Martin Marietta, let's see,
20 two and a half months after we announced the transaction, we
21 began making enormous changes. And those changes included,
22 as I said, closing 8 million square feet of plants. We
23 closed 12 entire plants. We are now in the process of
24 moving two plants from New Jersey and Pennsylvania to
25 California, entire plants, to combine with a bigger plant

1 that was already in California. We will have,
2 unfortunately, had to lay off 19,000 people because of this.

3 We have contracts being moved from one location to
4 another.

5 It just wouldn't be possible to approach putting
6 the pieces back.

7 And I should also say that, in our mergers, in
8 order to get maximum benefit, we have totally integrated the
9 two cases. It hasn't been a case where an automotive
10 company bought a tooth paste company. In that case, what
11 you propose might be very possible. I'm not familiar with
12 that kind of case because we haven't dealt with that.

13 But when you combine two automotive companies, if
14 they're really going to get the benefit of synergy, I think
15 one has to do, as we have; and that is, we have one chain of
16 command, one set of plants. You can't tell who came from
17 where.

18 In fact, our company today is really a combination
19 of about seven different companies over the last half dozen
20 years.

21 COMMISSIONER VARNEY: Around here, they call it
22 "unscrambling the egg."

23 MR. AUGUSTINE: Well, that's -- I wish I -- that's
24 better than the worm analogy.

25 COMMISSIONER VARNEY: But I'm thinking maybe

1 perhaps something that's kind of between what you suggested
2 in studying the outcomes in sort of the starkest example of
3 unscrambling the eggs.

4 Perhaps we ought to, in some -- not necessarily
5 your mergers but in some of our more controversial mergers
6 -- agree that we're all going to come back to the table in
7 two years and we're going to take a look at what our
8 assumptions were and what the parties' predictions were.

9 And if we need some remedial action, short of
10 unscrambling the eggs, that we ought to -- I think that
11 might help businesses that come in the door to be a little
12 more realistic about what they think is going to happen down
13 the road. And it might help us build more of a track record
14 on bearing out our assumptions.

15 I'm a little concerned that business would find
16 that untenable because of the lack of certainty that they
17 think it would present to them.

18 MR. AUGUSTINE: You took the words exactly out of
19 my mouth. The uncertainty would be very troubling. It
20 would sort of hang over your ability to operate the business
21 and over the market's view of your business.

22 So I think it would be hard to do in most cases.
23 There might be unique cases where there was an acquisition
24 made that was to be operated separately and no unusual
25 investments to be made in it, it was just to be continued on

1 where one might follow that process. But I would think
2 those would be the exceptions to the rule.

3 When you began, I thought maybe you were going to
4 say that when you revisit these two years later to ask the
5 companies to come in and revisit with you, from their
6 perspective, not with the idea of undoing or changing that
7 transaction but with the idea of, together, learning for the
8 next transaction that someone may have. And that, I think,
9 would be a great idea.

10 COMMISSIONER VARNEY: Perhaps they'd be a little
11 more forthcoming and candid if they didn't run the risk of
12 any remedial action on their part.

13 MR. AUGUSTINE: That could be.

14 COMMISSIONER VARNEY: On your suggestion for
15 private consultations, that's something that I've been very
16 interested in a slightly different way. And I have to say
17 that not everyone in this building agrees with me on this,
18 but I have thought that one of things that we ought to do --
19 although, we do have limited and shrinking resources -- is
20 engage more in technical assistance. I mean, it's difficult
21 for us because we're not structured the way Justice is for
22 staff to go ahead in advance of bringing a transaction to
23 the Commission to tell you what they think the Commission is
24 going to do on the transaction.

25 On the other hand, I think that one of the things

1 that we could usefully do is sit down with parties as they
2 are planning a transaction and give them what I would call
3 "technical assistance." These are the kind of things we are
4 going to be looking at. These are the kinds of measures
5 we're going to be looking for. These are the kinds of
6 issues that we are going to have concern about.

7 And I don't know if that differs from what you're
8 suggesting?

9 MR. AUGUSTINE: I think that would be extremely
10 helpful. And my suggestion really went a little beyond
11 that, that the companies could come in and -- as we did most
12 recently; and I thought it worked very well -- and say these
13 are the areas that we know you're going to be interested in,
14 or we think you are; and kind of put the spot light on them.

15 And one certainly couldn't expect the Commission
16 to take a position, but you could indicate that this is an
17 area of concern or this is not an area.

18 The difficulty, of course, as your question
19 suggests, is that privacy is critical in this
20 pre-announcement phase because, as you would know so well,
21 any break in privacy, the stock market begins to react. And
22 if it does, it can often undermine the deal. It makes it
23 impossible.

24 And, furthermore, it's hard to put these
25 transactions together with the employees all debating

1 whether it's a good idea or not, the public debating.

2 And, then, there's always those few individuals
3 that will try to take advantage of the knowledge they had so
4 that one just has to hold it pretty closely. And so one
5 needs private advice.

6 And anything that the Commission can do, not only
7 on a case-by-case basis but in general, to provide guidance
8 to people in business so that we have a better understanding
9 of what the risks are when we announce the transaction, that
10 we have a reasonable confidence of what we can do and what
11 we can't do. That is enormously helpful.

12 COMMISSIONER VARNEY: And my last comment goes to
13 your particular experience on DoD-FTC leadership.

14 I have to say from where I sat, I thought it was
15 extraordinarily good in this transaction -- Martin-Lockheed
16 transaction.

17 It appeared to me anyway that it was a
18 consultative process that the Defense Department did not
19 want to, at the highest level, say the transaction must go
20 through or the transaction must be stopped.

21 They, I felt, were very cooperative with us
22 saying, we think, in general, that this is a good
23 combination. There are some areas that you may have concern
24 about from a competition standpoint. We understand that,
25 and we want to work with you to see if we can get the right

1 solution.

2 I don't know how you experienced the relationship;
3 but from where I sat, it was very positive and very helpful
4 to our process, I thought.

5 MR. AUGUSTINE: We, of course, dealt with the
6 Defense Department and we dealt with the Commission. And we
7 had relatively little -- amazingly little insight into what
8 was transpiring between the Commission and the Defense
9 Department.

10 But I think it's the view of all of us who were
11 involved in that transaction from our company -- our two
12 companies that it was extremely well handled and that we
13 never felt that we were trapped between the Commission and
14 the Defense Department. There seemed to be a spirit of:
15 "Let's try to understand this and do what's right."

16 I would give very high grades to that -- to the
17 way that was processed.

18 MS. DeSANTI: I would like to follow up on
19 Chairman Pitofsky's question about R&D.

20 And as I understood your answer, I got the
21 impression that you were saying that there is actually very
22 little joint, base -- what might be termed basic research
23 among different companies in the defense industry.

24 Is that something that you see as a trend that
25 might come about in the future? Or are there business

1 reasons why that has not been happening yet that would
2 similarly mitigate against it and militate against it in the
3 future?

4 MR. AUGUSTINE: It's an interesting question.

5 I think that times are changing, and the answer
6 may change. But if one looks historically at our industry,
7 in spite of what many people think, it's an incredibly
8 competitive industry, far more competitive than many of the
9 commercial businesses that our company engages in; and we do
10 engage in about 5 or \$6 billion a year of commercial-type
11 work.

12 The reason for that is principally that, in our
13 business, you don't win or lose market share; you win or
14 lose the entire market opportunity. You either win the F-22
15 contract, or you lose it. You don't win the left wing and
16 lose the tail or something.

17 And, secondly, there are so few opportunities any
18 more, that if you lose, it may be 15 years before you get
19 another opportunity.

20 And because of that, companies in our industry
21 have been very loathe to share their basic research, even
22 the thrusts of it or the ideas. For example, our company --
23 the Lockheed part of our company was a pioneer in stealth,
24 and they certainly didn't want to share their work in
25 stealth with anybody else, even the basic research. So

1 there's been a reluctance to do that.

2 On the other hand, as the industry becomes more
3 globalized, for example, the semiconductor industry, it soon
4 became apparent that the costs of pursuing advanced research
5 were going up so much and that foreign countries were
6 working together, that U.S. industry had to work together.
7 And we're not at that point, I don't think, in our industry
8 for most basic research. And that's the reason we just
9 haven't seen much of it.

10 And I guess that's the bottom line: We just don't
11 do much of that yet.

12 MS. VALENTINE: I certainly understand that you
13 are in a bind when trying to tell us about the cost savings
14 and efficiencies that you think you will be realized in a
15 deal, that your attorneys are telling you things, there are
16 probably people on the Hill that are listening carefully for
17 things; and I also certainly appreciate that you've
18 established a good track record, as you've described the
19 three deals that you have done.

20 But you probably can understand that we have a
21 concern that history is not always predictive of the next
22 step and that at some point there will be such consolidation
23 you will have run all your synergies and efficiencies out
24 that either there are no longer economies of scale that can
25 be gained or something might change.

1 What, in that case, can you tell us -- or is there
2 anything you think you can tell us, you know, when the next
3 deal or the next deal or the next deal comes down the track
4 that would help us to understand whether, in fact, you are
5 realizing efficiencies or cost savings?

6 MR. AUGUSTINE: I fully appreciate the fact that
7 you have to have some basis for any decision you make and
8 that it's not fair for us to stand back and say we can't
9 tell you, because there are things that we can share and
10 should share.

11 First of all, in the case of -- if you'll forgive
12 me for going back to specific cases, but that's where my
13 familiarity lies -- in the case of the Lockheed-Martin
14 Marietta merger, we, between us, because of prior mergers,
15 had four separate spacecraft manufacturing facilities in
16 four different states. And it was apparent to us that we
17 shouldn't need four. And we didn't know whether we needed
18 one or two, but it probably wasn't three or four. And we
19 didn't have the faintest idea which ones. And that's the
20 reason it was so hard to say: "This is what the savings
21 will be."

22 But if we shared with the Commission openly the
23 data we were allowed to have, I think the Commission staff
24 could have, on its own, drawn a conclusion that you should
25 be able to save at least X dollars by looking at it.

1 So even though we weren't sure of the eventual,
2 exact construct, the savings would be there when we combined
3 these various companies. It was clear you didn't need two
4 headquarters. You only needed one CEO, one CFO. That gets
5 easy.

6 Another level that we found helpful -- and this
7 does fall into the problem that you point out, that the past
8 isn't necessarily predictive -- we did have data on the
9 percent dollar savings that we had been able to achieve from
10 various kinds of actions in the past; and so we used those
11 as kind of bands that we -- our experience has been when you
12 do this, you can save X to Y percent. And I think that can
13 be shared.

14 So I think one can provide a lot of raw data, if
15 you will, to the Commission and give the Commission a
16 reasonable understanding of what the probable outcome is
17 without violating the legal constraints that are placed on
18 us.

19 Furthermore, there is no reason the Commission
20 staff can't and doesn't talk to each company separately and
21 draw its own conclusions.

22 MS. VALENTINE: Actually, one last quick question.
23 Is that okay?

24 Can you think of any industries to which the
25 lessons of the Defense Science Board report would be

1 applicable other than defense?

2 MR. AUGUSTINE: I think the Chairman probably
3 would be better to respond to this than I. But I think that
4 any industry where you have a single, large customer or very
5 few large customers, there's probably relevance. And I
6 suspect there are other cases, but that one comes to mind
7 particularly.

8 I'd suggest NASA, the Department of Energy, and
9 even combinations of state governments that buy things, I
10 think there is relevance.

11 CHAIRMAN PITOFSKY: Bill?

12 MR. BAER: Good morning.

13 MR. AUGUSTINE: Good morning.

14 MR. BAER: I apologize for being late.

15 Just one question that I hope can be answered
16 briefly, because you have been most generous with your time
17 here this morning.

18 I appreciate that you feel strongly that
19 efficiencies need to be given appropriate weight in
20 transactions of the sort you've been through. And you've
21 been through what? three in the last four years. You
22 probably have the distinct honor of being, you know, twice
23 investigated by us and once by the Antitrust Division, on
24 major, weighty investigations.

25 A number of us weren't here when you went through

1 those investigations; and the question I have for you is
2 sort of a base line question. How well do you think both
3 agencies evaluated your efficiency claims in those three
4 transactions? And what specifically would you have us do
5 differently?

6 MR. AUGUSTINE: The answer to that might be
7 career-limiting, but let me try to be candid.

8 I think that each successive transaction -- I've
9 only been involved in three major ones. I've been involved
10 in a number of lesser ones -- but each one was better than
11 the one before in terms of the efficiency with which it was
12 handled.

13 And I think one of things that helped a great deal
14 was there was more interchange on a more informal level as
15 people got to know each other and trusted each other and as
16 time went on.

17 The process of our going off and collecting
18 500-plus cartons of documents and dropping them on the
19 doorstep and then going away, waiting for the answer to come
20 over the transom, was a very unrewarding approach.

21 And so the give and take and iteration. And one
22 of the things that was particularly helpful, I think, in our
23 Lockheed-Martin Marietta merger was that the Commission
24 permitted our general counsel and his staff to come in and
25 share our views on what we thought you might be interested

1 in before we ever even started the clock on the review that
2 you were conducting. And so when you really began the
3 review, a lot could be set aside. And that worked very
4 well.

5 The first transaction, which was General Electric
6 Aerospace-Martin Marietta one, and -- which was my first
7 experience at this type of thing on a large scale, and it
8 was handled by the Justice Department -- was, frankly,
9 difficult because, a day or two before we were going to
10 close, it looked like there was a chance the entire
11 transaction could, in our vernacular, crater. And that's
12 very unsettling.

13 And I think anything that could be done, if one
14 assumes that such transactions have value in some cases,
15 anything that can be done in advance to remove the
16 uncertainty would be very helpful.

17 And I'm not suggesting that the Commission needs
18 to be more lenient in any way; but if it can reduce those
19 elements of uncertainty, that's a huge step in terms of
20 letting business people have the courage to step up to
21 these. Because if they come apart, the consequences are
22 really dreadful.

23 MR. BAER: I appreciate that.

24 In terms of your consolidation savings,
25 motivations for each of these three transactions as you

1 dealt with a downsizing defense industry, do you think the
2 agencies gave appropriate attention? It's hard for you to
3 tell how much weight we gave to these claims of
4 consolidation savings and efficiencies.

5 But were you heard out fairly?

6 And from your perspective, do you think you were
7 given some measure of appropriate weight in the decision
8 making process?

9 MR. AUGUSTINE: As you say, we really had no
10 insight into the weight that was afforded this notion.

11 But in terms of fairness of being given an
12 opportunity to be heard, I would say in all three cases, we
13 clearly had that. In some cases, it was more give and take;
14 and that was helpful. But I think in every instance we had
15 our so-called day in court.

16 One of the things that helped in our instance was
17 that -- and I would encourage this where it's possible in
18 the future -- and that is for the companies who are
19 promoting these ideas to step up and say we'll carry the
20 risk of the investment. And that's a good way that you can
21 smoke out how confident they are in the ultimate savings.

22 I would like to add a footnote if I might because
23 we in our company have tended to talk a lot about savings
24 because they're fairly measurable and fairly easy to
25 understand.

1 But we had two objectives probably of equal
2 importance in undertaking these consolidations. One was
3 cost efficiencies. But the other was market presence, if
4 you will, or market competitiveness.

5 We have often said that the arithmetic of mergers,
6 as we have derived it, is that when it comes to cost
7 savings, one plus one has to be one and a half; and when you
8 look at market impact, one plus one has to be three.

9 And we have found cases actually where -- quite a
10 number -- where the two parts of the company come together
11 and one said: We can't bid that because we don't have so
12 and so. And the other says: We can't bid that because we
13 don't have so and so. And they went together and bid it and
14 won and, presumably, better served the customer, too.

15 Now, one could say, well, you could have done that
16 anyway by teaming, except the pieces that came together they
17 wouldn't have known about because they were -- we kept those
18 as competitive secrets.

19 So there is that benefit that I wouldn't want to
20 short change.

21 MR. BAER: Thank you.

22 MR. AUGUSTINE: Thank you.

23 CHAIRMAN PITOFSKY: Well, Mr. Augustine, thank you
24 very much for giving us your time and sharing your thoughts
25 with us. We really appreciate it.

1 MR. AUGUSTINE: Thank you very much.

2 CHAIRMAN PITOFSKY: Are other witnesses here?

3 Mr. Hudler, welcome.

4 Our next participant is Donald Hudler, GM Vice
5 President and President of Saturn Corporation, a
6 wholly-owned subsidiary of GM. And he's also a GM Vice
7 President.

8 Mr. Hudler is responsible for Saturn's day-to-day
9 operations, including: Sales, Servicing, and Marketing; the
10 Spring Hill, Tennessee, manufacturing operation and
11 management of Saturn's UAW partnership.

12 Before he was appointed President of Saturn, Mr.
13 Hudler served as Saturn's Vice President of Sales, Service,
14 and Marketing from February 1987 to August 1995.

15 He previously held a variety of positions in GM,
16 including, most recently, General Director of Sales
17 Operations for General Motors Customer Sales and Service
18 Staff.

19 From 1980 to 1983, he served in Madrid, Spain, as
20 Regional Director of Marketing for Belgium, France, Italy,
21 and Spain.

22 Mr. Hudler, welcome to these proceedings.

23 MR. HUDLER: Thank you.

24 Mr. Chairman, Commissioners, good morning.

25 We appreciate the opportunity to appear here this

1 morning. This morning, I will be using Saturn Corporation
2 as sort of an example of -- to make some of the points that
3 I will be talking about here today.

4 But as the automobile industry becomes truly a
5 more global industry, which it, indeed, is becoming, there
6 are certainly cost pressures from all aspects of the
7 business.

8 And it's incumbent upon us, to survive and be
9 competitive, to examine all phases of the business. I'm
10 sure you're familiar with some of the wrenching problems
11 that General Motors has undergone in the last several years;
12 but we spent a lot of time taking a look at the product
13 development, the engineering manufacturing side of the
14 business and have made significant progress in terms of
15 becoming more competitive not only from a cost basis but
16 from a content basis in our products where they are viewed
17 as more competitive and the equal of any produced anywhere
18 in the world.

19 One part of the business that often isn't looked
20 at in quite the same way is the distribution side of the
21 business. And the distribution side typically generates
22 about 20 to 25 percent of the total cost -- represents that
23 percentage -- of a passenger car or truck to the end
24 customer.

25 So we think that is a significant part of the

1 business and needs to be examined and needs to be made just
2 as efficient as our factories are or the engineering process
3 is.

4 And that represents kind of a paradigm shift in
5 thinking for a lot of people in the industry, certainly a
6 lot of people within General Motors, as it did for me as I
7 began to become far more familiar with it than I had. And
8 I, fortunately, had the chance to look at this in other
9 countries and learn from some of those experience.

10 Today I would like to briefly explain to you some
11 of the approaches we think are necessary not only for us to
12 be more competitive but probably some of our domestic
13 competitors as well because some of the examples I will use
14 really apply pretty much across the industry.

15 But our new approach is really designed to contain
16 or even reduce cost of distribution and ultimately reduce
17 cost or contain cost to the consumer.

18 We have to do a far more effective job in
19 targeting products to meet the direct customer requirements
20 so that we can enhance the purchase and ownership experience
21 and thereby earn more of the customer's business for General
22 Motors.

23 In order to make some of the necessary changes, we
24 need to overcome some of the obstacles that we often face
25 today. Some of those we have to look in the mirror for.

1 They are our own practices, our own traditions and customs.
2 Those are the internal obstacles.

3 But there are also some external obstacles, such
4 as very restrictive state laws, local franchise laws and, in
5 some cases, even arbitrary antitrust rules.

6 So I would urge you to help us and help the rest
7 of the industry to overcome some of these obstacles that,
8 what we call, a mature industry does face and to permit
9 General Motors and others to have the same flexibility that
10 new entries enjoy in the marketplace.

11 About 20, 25 years ago, the Japanese made an
12 entrance into this market. They didn't have the tradition
13 and set patterns to overcome. So they had pretty much a
14 free rein as to where they were going to initially have
15 representation, where they were going to locate dealerships,
16 if you will. They could do what best met their needs and
17 what they felt would best allow them to serve the customer.

18 After the initial wave of the Japanese coming in,
19 there has been sort of a second wave, including makes like
20 Lexus, Infiniti, and, of course, Saturn, where we had a
21 clean sheet; we were pretty much free to do a lot of the
22 things that we wanted to do because we didn't have
23 locations; we weren't bound by the franchise laws. After we
24 were in business, we certainly had to respect them; but we
25 had a chance to do things differently up front.

1 And I'll talk about those in a few minutes.

2 There are some other entries from offshore that
3 are going to continue to come in. Daewoo from Korea. They
4 have some very innovative ideas that are now being piloted
5 in the UK. And, of course, China is on the horizon.

6 So I think this business will truly become a very
7 intensely competitive global business, and all of us need to
8 be as efficient as we can in order to survive as well as
9 provide the best value to the consumer.

10 I would like to give you a little bit of
11 background on some of the benefits of Saturn's clean sheet
12 approach and some of our experiences and what we did to go
13 about better satisfying the customer, providing greater
14 value to the customer.

15 I should say that Saturn has not finished with
16 change or experimentation because the only sure thing about
17 our business and probably many businesses is change itself.
18 I dare say that Saturn will look very different 10 years
19 from now than it does today; and if we don't, we probably
20 won't survive. And that same point could be made for most
21 of the other makes because the consumer is going to demand
22 that in order to be competitive and provide the right value
23 to the customer.

24 There are three essential elements to the Saturn
25 distribution system and to what I would describe the General

1 Motors system of the future.

2 And first would be large sales territories with
3 fewer dealers but with each of those dealers operating more
4 stores or having more locations.

5 The second major point is single-line or focused
6 distribution that enables you to have an almost maniacal
7 focus on satisfying the customer and building that brand
8 equity, which is really what creates value to the consumer.

9 Also, the third element is really what we call at
10 Saturn a team or a partnership-like atmosphere in working
11 with our dealers to help us manage the business.

12 It isn't a partnership in the true sense of the
13 word where we each have co-investments in a business. But
14 if you would consider that General Motors has nearly \$2
15 billion invested in our manufacturing operation in Tennessee
16 and have 9,000 people working there and look at the Saturn
17 retail system as one, the retailers have an equal amount
18 invested. They have invested \$2 billion in the Saturn
19 franchises across the country, invested or committed to come
20 on board within the next several months. They also employ
21 13,000 people. So it's a huge system that really begs for
22 considerable input as to how we manage the business.

23 I choose to look at it that that's a tremendous
24 talent pool and if we don't take advantage of that and
25 benefit from it, shame on us. Because these people are far

1 closer to the customer than any manufacturer can ever
2 possibly be. So we really have to create a climate where we
3 can work closely together in terms of figuring out the most
4 efficient way to reach the consumer and to provide most
5 value to the consumer for that's the only way we will
6 succeed in the marketplace.

7 The first element of our success in terms of
8 larger areas really represents the opportunity for retailers
9 or dealers to enjoy significant economies of scale. As I
10 mentioned earlier, 20 to 25 percent of the transaction price
11 of a car is added to the car after it is shipped from the
12 factory. That includes mark-up, advertising, warranty,
13 overhead, all of the things necessary to move that car from
14 the end of the assembly line to a customer's driveway or
15 garage. So that's a significant amount of money to go
16 after.

17 By reducing the number of dealer/operators and
18 assigning larger territories, we encourage them to operate
19 more stores in the territories to utilize flexibility in
20 terms of facility configuration.

21 In other words, take advantage of what exists in
22 that marketplace, whether that be individual sales locations
23 with separate service that may be equally accessible but
24 perhaps built on lower cost land, and have the showroom,
25 where exposure is so critical, located on higher cost land,

1 which is a significant part of the cost structure in an
2 operation.

3 We also can get rid of some redundant facilities.
4 If a Saturn retailer, for example, is operating three or
5 four stores, he can operate one used car operation or
6 perhaps two. You can have one body shop. You can
7 consolidate management where you have more professional
8 management such as trainers that can devote full time making
9 certain that people are equipped and knowledgeable about how
10 to best take care of the customer. You simply can't afford
11 to do that in smaller stores. It takes the economy of a
12 larger operation to able to do that.

13 In the market area approach, you can also pool
14 inventory which allows a retailer to save maybe 20 to 25
15 percent of inventory costs because you pool the inventory or
16 have the opportunity to in one or two locations; you can
17 move it back and forth and, as a result, have less
18 inventory, have the right inventory, and have a greater
19 response time to the consumer.

20 It also has enabled our retailers to enjoy about
21 \$150 to \$200 per cost reduction in advertising expense,
22 because you're advertising two locations or three locations
23 in the same ad; and you can either buy more clout in the
24 marketplace to be more competitive, which is what we did
25 initially to get started in building that brand equity. Now

1 it allows us to provide greater value and additional service
2 to that consumer, and there are some significant savings
3 that accrue to us from that.

4 It also really does allow us to streamline the
5 facility investment in a significant way.

6 There's a further savings for the manufacturer in
7 terms of fewer locations, fewer dealerships to contact and
8 to support. And that represents a significant savings, and
9 I'll come back to some of those numbers in just a minute.

10 But we think that the bottom line on what we call
11 our market area approach -- that is really allowing a single
12 operator to operate three, four, or five stores in an area
13 and have a lot fewer operators in a major market than is
14 prevalent today -- probably represents a savings between 4
15 and \$500 per car, which can be passed along to the consumer,
16 can allow us to provide more value to the consumer, that can
17 be used in a variety of ways. But the ultimate test as to
18 how we earn your business -- how we earn your business -- is
19 a kind of value you perceive as consumer in the product that
20 we offer for sale.

21 We think that there's a further gain for Saturn in
22 terms of allowing us to be much closer to the customer. By
23 have fewer stores, fewer operators, we can really better
24 understand that customer.

25 I will give you a couple of examples of that. The

1 Saturn operation has 350 stores nationwide at the moment.
2 We have 170 operators. So the typical Saturn
3 dealer/operator has, currently, two locations. That varies.
4 Some have one; some have three or four. The -- comparing
5 that 350 locations, Toyota, Honda, and Nissan have anywhere
6 from 1,000 to 1,200. They are all in that range. Buick,
7 Oldsmobile, Pontiac of General Motors each have about 3,000
8 locations. And we all sell about the same number of cars.

9 So, it's obviously far more efficient to support
10 350 locations than it is 3,000 or even 1,000 to 1,200 for
11 that matter. And that's exactly what Infinity and Lexus did
12 when they came in, because they have about 120 to 150
13 locations.

14 So there has been a real effort to provide greater
15 convenience, more professional service, and a greater focus
16 on a single brand from the people who seem to be doing the
17 best job of satisfying the consumer to kind of follow that
18 formula.

19 We think that a more consistent, focused approach
20 on single-line representation will be a real key to
21 revitalizing General Motors network.

22 Saturn has established a strong, very easily
23 identifiable image; and I would cite as an example, when you
24 see one of our ads, you know it's a Saturn ad; there's clear
25 focus on it. When you see a facility, there's clear focus

1 on Saturn. There aren't four or five different makes sold
2 in that same store where you aren't really sure what is
3 there. And when you have a variety of makes, you simply
4 don't have the professional expertise of the sales
5 consultants understanding the product, understanding the
6 competitive products, where they can really help someone buy
7 a car rather than focus on selling a car. And we think
8 there's a significant difference in terms of the way the
9 product is presented to the consumer. And I can attest that
10 the formula seems to work pretty well. It has for five
11 years.

12 But General Motors divisions have recently
13 undergone a major effort to refocus the product and the
14 marketing efforts to build a more distinct image. The
15 products in the future will be more focused on brand, will
16 be more focused on the needs of the consumer they are going
17 after. So there will be more specific or distinct products
18 aimed at a narrower segment of the market where there is
19 less proliferation, less overlap and, we think, a lot less
20 confusion to the customer, certainly a lot more efficiency
21 which will lead to greater value for the consumer.

22 We think that by virtue, within General Motors, of
23 having Saturn as a laboratory that there has been a unique
24 opportunity to understand some of these issues and
25 understand it in a way that might put us a little bit ahead,

1 at least we hope, of some of your friendly competitors.

2 We intend to work in the future to represent that
3 over -- to reduce that overlap in the marketplace, overlap
4 in GM franchises and non-GM franchises. We want to focus on
5 General Motors, have only General Motors' products sold at a
6 General Motors' dealership and focus on a single brand,
7 wherever that's a problem, smaller markets. Rural areas
8 there may have to be some combining of makes in order to
9 reach people in those markets. But we think you're going to
10 see a lot more focus if we can work together to get this
11 done by having fewer products, fewer makes, sold in single
12 stores.

13 We think that's a far more efficient way to go to
14 market and think that the real winner, when that's
15 accomplished, will be the consumer who will end up with
16 higher value.

17 As a distribution system enters into this remaking
18 itself, we need to adopt the idea that there's more to the
19 brand than merely the vehicle itself. It's that entire
20 shopping/buying/ownership experience which can add the value
21 to the customer and provide them increased satisfaction in a
22 far more efficient way.

23 We think that the consistency and distinctiveness
24 in facilities is a significant factor. Where you have a
25 uniform look across the country -- and, first of all,

1 there's some obvious advantages in design costs by having a
2 single look -- but also that facility appearance and
3 facility look is an advertisement for your product. It's
4 not unlike McDonald's or Burger King or any of the brands
5 that are so successful have adopted, and yet there are very
6 few of us who have done that to date in the automobile
7 industry. We think it's time to begin to do that.

8 As we examined and developed the marketing
9 strategy, market plan for Saturn, we first took a look at
10 all of the great providers of value and service. We looked
11 at service industries. We looked at the hospitality
12 industry. We spent a great amount of time with companies
13 like Holiday Inn, Marriott, SAS Airlines, McDonald's,
14 Disney, Ritz Carlton, and Nordstrom.

15 We felt those people were generally regarded as
16 providers of consistent high-value service, obviously
17 reaching a lot of different price ranges. But what they
18 did, they did extremely well. And we learned a tremendous
19 amount from those people.

20 The one thing we learned and saw in all of those
21 operations can be summed in a single word, and that's
22 "consistency." They did the same thing every time; you knew
23 what the brand stood for; you knew what it represented; they
24 had built significant brand equity. And we believe one way
25 they were able to do that is by a singular focus on that

1 product and representing high quality in a consistent way
2 every day.

3 I could use Marriott as an example in a different
4 fashion because they have different brands. They have the
5 Fairfield Inn, Courtyard, and Marriott Resorts, all aimed at
6 different market segments, different needs. And they do
7 that very, very well, not unlike PepsiCo with Pizza Hut,
8 Taco Bell, KFC, but different products, single focus on
9 those products, but a consistent formula for delivery.

10 But we believe that to be successful, we need to
11 emulate that in the automobile business; and we would like
12 to have each of our dealers in the future focus on selling
13 and servicing single brands and only those brands in their
14 facility which will obviously represent significant change
15 and take considerable time to accomplish this. But that's
16 clearly the direction that we would like to go.

17 We think that the customer service, that that kind
18 of system can provide, would represent a real breakthrough
19 in the industry. And if you compare the Saturn level of
20 service satisfaction to others, that's one of the keys that
21 enabled us to deliver that kind of experience to the end
22 customer.

23 The reality of the GM dealer system is that we
24 have lost the focus. Since 1970, we have lost more than
25 two-thirds of the single-line stores in the United States to

1 dueling and joining with other makes.

2 At the same time, we have also lost considerable
3 market share; and we think that there's a linkage there,
4 certainly not the sole reason, but there's clearly a linkage
5 that we've not only lost our way in some other areas but we
6 lost the focus and the distribution part of the business.

7 GM today currently has 85 different configurations
8 of dueling patterns across the county. So it's mind
9 boggling. And no wonder the consumer is confused. We're
10 confused ourselves.

11 But when you approach someone that's selling two
12 or three different brands, you aren't really sure who they
13 represent. And that isn't the kind of confusion customers
14 want to take with them when they go into a showroom to find
15 what is probably the second most expensive purchase that
16 they will ever make.

17 In fact, if you look at the cumulative purchase of
18 automobiles over a life time, that will be the single
19 highest purchase most Americans ever make. It will exceed
20 the value of their home. So we think it's a significant
21 purchase and needs to be dealt with properly and sensitively
22 by the service providers.

23 We think that this erosion of brand and loss of
24 single-line representation has clearly impaired and reduced
25 General Motors' effectiveness in the marketplace.

1 There are some statistics, but I'm not going to
2 bore you with a lot of them; but a couple of them are very
3 striking.

4 If you look at the sales efficiency of single-line
5 stores, which is the way we in the industry kind of judge
6 the effectiveness and performance, in single-line stores,
7 it's about 120 percent effective in relation to the
8 potential in that market. In dual stores, it's about 70
9 percent. So it's a significant difference. And if you're
10 only 70 percent efficient, you're not only losing a lot of
11 business, you've got to make that up some where; so you add
12 more costs by putting in more stores. And it's kind of a
13 dust spiral. But we think that there's clearly a better way
14 to do that.

15 One of the other things that it does enable us to
16 do by working more closely with the dealers as our partner
17 -- and their investment certainly begs that we do that --
18 but the Saturn retailers literally help us manage the
19 business. We think we make them better, and we know that
20 they make us better because we are more responsive to the
21 customer.

22 Some of the examples of that -- of how we do that,
23 what enables us to do, is we have what we call a
24 "single-voice" or "one-voice" advertising, where that --
25 whether it be national advertising, whether it be area or

1 regional advertising, or whether it be local; but it all has
2 the same tone. It all has essentially the same message.

3 So much advertising in our business is wasted
4 because the regional or local advertising is
5 counterproductive to the national message; and it really
6 neutralizes the whole message to the point that the consumer
7 is confused.

8 But we think it allows us, by having a clearer
9 focus and fewer numbers of partners to deal with, a clear
10 opportunity to have a better focus in all of our marketing
11 efforts, including advertising which represents a
12 significant part of car costs. It represents probably -- if
13 you would look at national, regional, and local advertising
14 -- 6 to \$700 a car.

15 So if you can make that message more effective,
16 you either have more clout in the marketplace by spending
17 that same amount of money, or you can save part of that,
18 pass it along to the consumer in a number of ways. Whether
19 it's more value or lower prices, you have those wonderful
20 options.

21 Another way that this partnership enables us to
22 work more closely is, every person in a Saturn store is
23 trained, whether it be the receptionist, whether it be the
24 person who moves cars out on the lot, or whether it's the
25 person who faces day-to-day directly with customers and are

1 trained anywhere from 2 to 20 hours initially; and then
2 there's an ongoing training program that we developed
3 jointly with our dealer partners. And it's a lot more
4 appropriate. It's utilized effectively. There isn't waste
5 in the system. And the most important benefit is that it
6 gets done, people participate in it, and it allows us to do
7 a far superior job in taking care of the customers in
8 meeting their needs.

9 We also do some unique things by actually bringing
10 these same people in as they're being trained and they
11 actually go out and help build cars on the assembly line.
12 It builds marvelous rapport with the people that build cars.
13 It keeps the people that build cars focused on the customer.
14 And they both come away, the car builder or the car sellers,
15 more enthused and more committed to what we're all about.

16 You simply can't do that if you're selling 8 or 10
17 different brands in the same store because the messages are
18 all a little different; and so we want to reinforce this.

19 Those are a few examples of how we benefit.

20 We also, when we bring people into our
21 manufacturing complex in Tennessee for this training and
22 car-building experience, we also spend up to a day listening
23 to owner calls. And it's quite a thrilling experience to
24 hear what your customers have to say about you. And we have
25 it arranged so that when customers call, we have the

1 retailers from those areas listening to those calls.

2 We have no idea whether they're going to be
3 compliments, whether they're going to be complaints, whether
4 they're going to be suggestions about product improvements.
5 And we get about an equal amount of calls in those three
6 categories. But it really keeps all of us a lot more
7 customer focused. As I like to say, it does all of us good
8 to feel the hot breath of the customer because we better
9 understand their needs and better understand our
10 shortcomings and can take whatever corrective action we need
11 a lot more quickly if we've listened to it first-hand.

12 The retailers, by working together, also provide
13 significant information for us on model acceptance, on
14 design features, on option contenting, on price levels,
15 where we're on the market, where we may be off the market.
16 They've helped us develop marketing programs that are a lot
17 more real world. They helped us develop a used car selling
18 process where we'll begin selling used cars exactly the way
19 we sell new cars.

20 And you simply cannot do that unless you work
21 together with the retailers and have that opportunity.

22 We've had that opportunity because we started
23 fresh, and we didn't have a lot of baggage, and we didn't
24 have a lot of numbers out there; and you could really make
25 this happen. And when you have 3 to 4,000 -- in Chevrolet's

1 case, 4500 -- dealers, it's very, very difficult to do some
2 of these things.

3 But our mutual goal at Saturn is to have every
4 Saturn owner not only satisfied but enthused about the
5 product whereby they become an advocate for the product and
6 will tell others about it.

7 Those are the benefits of what we call "brand
8 equity" and the single focus on a single brand.

9 Fitting fewer, more efficient dealers, located
10 where the customers are and focusing them on the product
11 really allow us to be fully competitive with some people
12 that have been at it a lot longer than we have to have an
13 owner base to work from.

14 An example of some of the benefits of this is that
15 70 to 75 percent of Saturn's business comes outside of
16 General Motors. 50 percent of our total business comes
17 directly from imports. And we kind of enjoy that, I have to
18 say. It's fun to be able to take someone out of a car that
19 they really like, that came from a foreign land, and put
20 them in a Saturn automobile.

21 We think these kinds of things are possible if you
22 can really get at the distribution system and create an
23 advantage for yourself.

24 85 Percent of Saturn owners choose to come back
25 for customer-paid service for things like oil changes. It's

1 unheared of in this industry. The Japanese enjoy about 40
2 percent of that business; the domestics, typically, 20 to
3 25. But people come back by choice not because they have
4 to. And we have to earn that. We have to be cost
5 competitive with the Jiffy Lubes, the Fast Change, fast
6 service areas, service companies, service providers, because
7 they do a good job; they're fast; they're efficient. And we
8 have to go head-to-head with them and offer the same kind of
9 value package.

10 According to the J.D. Power survey, which is a
11 very highly regarded survey of customer values and a lot of
12 different businesses, particularly in the automobile
13 business, Saturn is number one in the industry in sales
14 satisfaction, ahead of all of the foreign, all of the
15 domestic makes. And we attribute that to a direct result of
16 a lot of things that I have spoken to earlier.

17 I might also say that we are selling all the cars
18 that we can produce. So instead of trying to figure out how
19 to sell more at the moment, our job is to figure out how to
20 build more, which is, if you have to have a problem, always
21 the one to take in our business.

22 And while Saturn may not be an exact blueprint for
23 the rest of General Motors or for the industry, we think it
24 has allowed a paradigm shift, not only within General Motors
25 -- because a lot of Saturn retailers have a whole lot of

1 other franchises that they operate separately. And I don't
2 know of a make in this business that hasn't had what we call
3 a "Saturn dealer meeting," that is, people that represent
4 Ford and Toyota and others that hold Saturn franchises have
5 been summoned to their factory to understand how we did it.
6 And a lot of people are trying to emulate what we have done,
7 which kind of challenges us, tries to make us work even
8 harder and continue to change and evolve. And we have a lot
9 of ideas that we want to pursue even ourselves, but we do
10 have the flexibility because we aren't bound by so many of
11 the franchise laws because we do have these larger areas and
12 have a lot more flexibility to locate facilities, whether
13 they be sales or service.

14 What we would hope for, as we drive for more
15 efficiency, is to be allowed the opportunity to innovate.
16 If we don't get some of that help, it will be innovation and
17 our business will be limited to the new entries. And I
18 think we all see consolidations and distribution on all
19 kinds of business, whether it be electronics with people
20 like Circuit City or Best Buy, whether it be home products
21 such as Builders Square, Home Depot, or HQ, they all provide
22 great service.

23 The regional malls represented a major change. I
24 don't hear anyone crying to bring back the corner grocer.
25 Supermarkets lead that change. But I think we have to have

1 the climate, the flexibility to work with state franchise
2 laws that would allow us the consolidation, would allow us
3 the opportunity to work more closely with our retailers to
4 help make these things happen in the most efficient way as
5 possible.

6 We also need some help in the ability to select
7 dealer candidates, because so many of the state franchise
8 laws are focused on buy-sells that exist where we are almost
9 bound to take the person that the outgoing dealer has chosen
10 to sell to. We don't think that's the best way to get good
11 representation. The selling dealer has no interest in that
12 store once they leave. So the manufacturer is left to do
13 business with someone that may not be the right business
14 partner. We want to be fair. I'm proud to say that we've
15 only had two Saturn franchises sell in five years, which is
16 kind of unheard of in our business. So we haven't,
17 ourselves, been faced with this dilemma. I think we have
18 some unique provisions within our own agreement that does
19 allow us a lot more control because of a clearly defined
20 process that we have.

21 But those kinds of processes don't exist for the
22 rest of the industry and do represent major change. So
23 there would need to be some real relief there in order for
24 us to proceed quickly with a transition like this.

25 And I guess, finally, we would like you to just

1 judge our business conduct by the totality of the
2 circumstances and carefully examine the efficiencies
3 involved maybe in a way that hasn't been thought of
4 previously.

5 Because arbitrary rules and regulations that are
6 based on presumptions of market power are, we believe,
7 invalid in today's business climate because we also believe
8 market power doesn't really exist. The real power is in the
9 hands of the consumer; and that's where it should be.

10 So, Mr. Chairman, Commissioners, we appreciate the
11 chance to be here. Thank you very much, and I would be
12 happy to answer any questions that you might have -- or
13 attempt to answer any questions.

14 CHAIRMAN PITOFSKY: Well, thank you very much.
15 It's a fascinating insight into what could be quite a
16 departure in the way in which automotive distribution is
17 conducted.

18 I can understand -- I can certainly understand all
19 you're saying about efficiencies of scope and scale in
20 having franchisees with broader territories and more
21 outlets.

22 But, contrary minds, suspicious minds, will say:
23 Now, wait a minute here. That's all very well. But what
24 consumers will be deprived of is the chance to go around, as
25 they do now, to the various Toyota dealerships.

1 Look, suppose the Saturn dealer owns all the
2 outlets in Washington and the suburbs, you can't play one
3 Saturn dealer off very well against the other the way we now
4 can with Buick dealers and Toyota dealers.

5 What's your answer to that?

6 MR. HUDLER: Well, first of all, when you have 3
7 percent of the market, there are lot of other people out
8 there that are going after us. So while we like to think we
9 have a good product, there are a whole lot of good choices
10 out there for the consumer.

11 The Saturn owner, 52 percent of our buyers are
12 college graduates with a median income of between 55 and
13 \$60,000. So we're appealing to a fairly well-informed
14 audience that can make choices, and they make it very well.

15 We think the marketplace really polices that. The
16 investors in the dealerships aren't investing in them to not
17 sell cars. And they simply won't sell them if they don't
18 represent good value and offer them at a fair price in the
19 marketplace.

20 I think the bottom line on how we're doing might
21 be summed up in understanding the resale value of our cars.

22 We have the highest resale value in the industry
23 as a percentage of original price, higher than Mercedes,
24 Lexus, every make out there. That's really value to the
25 consumer. And not a lot of people think about that up front

1 because you're trying to buy a car; you aren't thinking
2 about selling it. But the fact is that that sells a lot of
3 cars for us because people that are enthused about our
4 product tell their friends and neighbors and relatives of
5 this experience.

6 So I think you have to look at the total, not just
7 the initial price; and I think we're very competitive up
8 front. The marketplace tells us we are. But we also
9 provide a nice surprise when it comes trade in time.

10 CHAIRMAN PITOFSKY: Mary?

11 COMMISSIONER AZCUENAGA: Well, that was very
12 impressive to hear how you have gone about focusing your
13 marketing efforts, and I enjoyed it a lot. I particularly
14 was interested when you said you make efforts to feel the
15 hot breath of the consumer. Because these hearings are, to
16 some extent, our effort to feel the hot breath of the
17 consumer.

18 So I will take the risk of asking you about a
19 question that occurred when you first said that some of the
20 problems you face are arbitrary antitrust laws.

21 And I guess my question is: Which of those have
22 you found most troubling? And can you give an example of
23 how that has worked in your industry?

24 MR. HUDLER: I think probably the best example I
25 could use personally is the fear or apprehension of working

1 openly with a group of dealers in the same market for fear
2 of getting together on price or other matters that would be
3 sensitive.

4 Because we have fewer dealers -- and we only have
5 10 markets where we have more than one operator in the same
6 market; those 10 markets happen to represent about 50
7 percent of the business, so that's a pretty good barometer.
8 Because of our having larger markets, market areas, we
9 haven't had that same depth of concern.

10 But having been with General Motors for years, I
11 know that those concerns do exist. Some of them may be
12 real; some may be imagined. But there's a perception by the
13 people that have to get the job done and some admonishments
14 by some of my colleagues on the legal staff that we need to
15 be very sensitive and careful.

16 And what that tends to do is make -- cause a lot
17 of people to avoid having those kind of meetings in the
18 first place.

19 I'll give you an example. In the city of Detroit,
20 one of the GM brands has 42 dealerships. They sell 7,000
21 cars retail a year. That's about 165 a year.

22 Saturn has 8 locations. We sell 17,000.

23 Now, you can't -- the average Buick, Olds, Pontiac
24 dealerships, when you take fleet sales out of it, and look
25 at one-on-one retail business, they probably sell between

1 120 and 150 cars a year of that make. They simply can't
2 focus on the customer because you can't make any money
3 selling 150 cars.

4 So the way you support it, you bring in a lot more
5 brands, because the market's only so large; you've got so
6 much proliferation that no one really is an expert on the
7 product; you don't have all of the parts; you don't have
8 people trained; you don't have all of the equipment. It's
9 kind of "Mission Impossible."

10 So I think that's probably one of the examples
11 where you would like to be -- feel free to bring in that
12 group of dealers and rationalize that network in some
13 fashion within that market.

14 I don't know whether eight is the right number for
15 this other GM division, but I do very well know that the
16 right answer isn't 42. You know, it's probably
17 realistically somewhere between 10 or 15.

18 Now that represents major change because there's a
19 lot of brick and mortar, a lot of investment; but there are
20 ways to rationalize that and rearrange franchises that can
21 be done. And I think there's a reluctance to step forward
22 and do some of that without having some recriminations or
23 spend a lot of time and delays.

24 COMMISSIONER AZCUENAGA: Well, it is true that we
25 watch over joint activities among competitors very

1 carefully; and, of course, there's good reason for that.

2 Some areas -- obviously, price fixing is always
3 going to be something we're concerned about and market
4 allocation, various things like that.

5 Can you give us some suggestions, practical
6 suggestions, about what we might do to help remove the
7 inhibition to meet -- that would allow these groups to get
8 together and talk about things that are not antitrust
9 concerns?

10 MR. HUDLER: I think maybe a more clearly defined
11 understanding of what's in bounds, what's out of bounds,
12 understanding the boundaries but also being willing to take
13 some innovative looks and kind of throw away the rules, and
14 maybe some pilot markets. Say: Okay. What can we do here?
15 How can we help rationalize this?

16 This will happen over time by itself, but it will
17 be a very slow, arduous process; the consumer will not be
18 the beneficiary; and the new entries stand to really gain.
19 People like Saturn can really benefit by this system being
20 kind of frozen in time. The "New Entries" game. That's how
21 the Japanese came when they came in because they didn't have
22 to consider a lot of the rules. That's how Lexus and
23 Infiniti have been so successful. Daewoo is coming. The
24 Chinese are coming.

25 So the new entries will be the people who bring in

1 innovation. And the people that are there, you know, will
2 be left to follow somehow. And I think all this is
3 eventually going to get done; but instead of taking 25
4 years, it would be sure nice to get rid of some of the waste
5 and redundancy in a much shorter time frame than that.

6 I don't know if that gets right at your question
7 specifically.

8 COMMISSIONER AZCUENAGA: It does. Although, I
9 still have some other questions about exactly how we go
10 about it; and I'm not sure how far we can figure it out
11 today. But perhaps I could just ask you one more question.

12 What specific kinds of things would they discuss
13 that you think would be all right to let go: we should give
14 some indication to talk about this or that, don't talk about
15 prices, but here's what you can discuss?

16 MR. HUDLER: Well, I think the reality is that
17 when you look at a market, it has a certain potential,
18 there's some fairly sophisticated ways to assess what the
19 potential is in that market.

20 Once you understand the potential, it's easy to
21 then calculate the number of stores if you were starting
22 fresh, as we did, that you would establish in that market in
23 order to be successful.

24 And the test is -- the test we had to withstand is
25 that we wanted to sell 300 to 350,000 cars. We felt that to

1 attract the caliber of investment necessary to get the job
2 done from really sophisticated, dedicated operators, they
3 would have to make a specific return on investment.

4 And we established that level through talking to,
5 literally, hundreds of them and people outside the business
6 and investment analysts. We came in with a figure of about
7 14 to 15 percent return on net assets.

8 So if you want to make that kind of return, you
9 then back into how many cars it is going to take to do that;
10 what kind of a service base; how much revenue we would
11 generate in parts and service.

12 We put an economic model together that led us to
13 that answer. The answer for us was 8 to 900 cars per store
14 was necessary to have a sufficient profit level that would
15 attract the caliber of investment required.

16 I mean, our job was really to raise literally \$2
17 billion in private capital without a car, without a factory,
18 and without a market plan; and somehow we were able to pull
19 that off. And we pulled it off by working with the
20 retailers involved. They helped us design the system. And
21 they benefit from it; we benefit from it; they're
22 competitive.

23 The marketplace is a wonderful policeman.

24 COMMISSIONER AZCUENAGA: I agree with that. Thank
25 you.

1 CHAIRMAN PITOFISKY: Well, I think you solved all
2 of our problems.

3 MR. AUGUSTINE: It sounds easy. Right?.

4 CHAIRMAN PITOFISKY: Thank you very much.

5 MR. AUGUSTINE: Okay. Thank you.

6 CHAIRMAN PITOFISKY: We appreciate your coming in.

7 MR. AUGUSTINE: Thank you. We appreciate it.

8 CHAIRMAN PITOFISKY: Is Mr. Pitts here?

9 Good.

10 Our final participant this morning is David Pitts,
11 President and CEO of Pitts Management Associates, one of the
12 largest hospital and health care consulting firms in the
13 nation.

14 As a principal of PMA, Mr. Pitts is directly
15 responsible for consulting engagements and strategic and
16 tactical situations. He has the reputation as a skillful
17 facilitator in forums involving boards, physicians, and
18 senior management.

19 He is also a national consultant in the Health
20 Care Administration to the Air Force Surgeon General, the
21 national President of Health Insights Foundation, and a
22 member of the faculty of The Governance Institute.

23 He is a corporate director of several businesses
24 in the insurance, banking, and health care industries and is
25 chairman of a hospital board of trustees.

1 Mr. Pitts, welcome to these proceedings.

2 MR. PITTS: Thank you, Mr. Chairman and
3 Commissioners. It's nice to be here with you today.

4 Unlike the other two speakers this morning, I
5 don't represent any specific corporation. I'm here, I
6 understand, because of my experience and the experience of
7 our company in working with hospitals and in the
8 consolidation process, the merger process that they are
9 undertaking today.

10 The health care industry, as I think all of you
11 know, is probably the largest industry in the country today;
12 and, yet, it's very much a cottage industry. It's a local
13 and regionalized industry and really not given to very much
14 consolidation on the national level.

15 And although today in the press we hear a lot
16 about one or two corporations that are very
17 consolidation-oriented and are in the for-profit vein with
18 investors, they represent something less than a fifth of the
19 hospital industry. And so you see a lot of publicity about
20 what they're doing. But, basically, the other four-fifths
21 of the industry is very local, regionalized, very much tied
22 to the community. And I think that creates some
23 difficulties that we've observed in the consolidation and
24 merger process from an antitrust point of view. And I want
25 to speak about some of those this morning.

1 Health care is very much an industry in
2 transition. And it's an industry in transition because it's
3 moving from a central fee-for-service basis to a capitated
4 basis, and that transfer has created considerable problems
5 throughout the industry.

6 For one, hospital care, particularly, has become a
7 mature industry, mature in the economic sense in that we now
8 have considerable excess capacity. And that's relatively
9 new in the business. Hospitals, for most of my working
10 life, spread over some 38 years, have been -- had not had
11 enough capacity to meet the demands and needs of the
12 community. That is no longer true. We have too many
13 hospitals. We have too many physicians. We have too many
14 beds.

15 This over, excess capacity has created a lot of
16 opportunity for managed care. And managed care,
17 essentially, is a capitated system that puts the risk of the
18 business on to the provider, the hospital and the physician,
19 as opposed to where it has traditionally been, on the buyer
20 or the insurance company.

21 As all of this underutilization, overutilization
22 has occurred, we find that hospitals have tended to
23 centralize tremendously.

24 Now, this merger process that they must go
25 through, in my view -- and I speak only for myself, not any

1 particular client -- the merger process that they must go
2 through is, essentially, complicated by what is known as an
3 efficiency study. And I would like to mention, just for a
4 minute, what that does.

5 As you those of you know who have been involved in
6 antitrust processes, an efficiency study takes -- this is my
7 view of what it does -- it tries to look at the parties as
8 they will be put together and say: What is duplicative as
9 far as programs are concerned? What is duplicative as far
10 as equipment is concerned? What type of avoidance can you
11 have on a capital basis? And what is duplicative as far as
12 management is concerned?

13 The process requires that you prepare a study that
14 will show how much money you can save.

15 Now, the difficulties that we've encountered when
16 we've tried to help hospitals do this in preparation for
17 getting approval -- or at least approval not to be reviewed
18 by either yourselves or the Antitrust Division -- the
19 difficulties are timing, essentially. It's very difficult
20 to know how you're going to put these efficiency studies
21 together if you don't know what you're going to do.

22 And we have never been in a situation yet where
23 people knew what they were going to do. Physicians are not
24 under the control of hospitals. In most industries -- and
25 the two fellows who spoke before I did this morning -- have

1 control of their major resources. Hospitals don't have
2 control of their major resource. That resource is
3 physicians. Very few hospitals have a situation where the
4 physicians are actually employed by the hospital.

5 So that means that your major resource, your
6 principal source of business, and whether or not you succeed
7 or fail is largely dependent on someone that is not under
8 your control.

9 Physicians, in my view, like most people, are very
10 opposed to change. They are particularly opposed to change
11 when it affects their economic welfare and their benefit.
12 Physicians are terrified of managed care. Hospitals are
13 essentially terrified of managed care. They've never had to
14 deal in a competitive situation as they must now.

15 Even more importantly, the buyers of health care
16 -- such as the federal government, large employers, like the
17 fellows who were here this morning -- want to put that risk
18 on the provider in such a way that it comes out as a unified
19 risk. Managed care wants one unified risk. In other words,
20 they want the physicians and the hospital to come together
21 and to give them a capitated amount. This is terrifying to
22 physicians who have always worked on a fee-for-service
23 basis.

24 So there's a lot of scrambling in trying to get
25 these two activities together. Physicians and hospitals

1 haven't got a clue about how they're going to do that in
2 consolidation. And if you get two hospitals together and
3 they say, well, we're going to come together and we're going
4 to form one hospital in this market and thereby taking out a
5 player in the market, how are they going to go about doing
6 that? And what you people want, in our view, and what the
7 Antitrust Division wants is a detailed report of how that's
8 going to happen, what you call an efficiency study; and the
9 purpose, as we understand it, is to indicate that the
10 societal values of the efficiency on the market overcome any
11 of the anti-competitive activities that might be available.

12 But the problem is, there is just no way to do
13 that at the time that you want it done. If you were going
14 to say, we're going to put these activities together and,
15 thereby, save millions and millions and millions of dollars,
16 what that basically means is that you are taking a lot of
17 people out of employment in the community, that you are --
18 you have much less need for the physicians -- the number of
19 physicians that you would have had to have to consolidate
20 programs.

21 The studies require very highly detailed accounts
22 of what's supposed to be done. There's simply no way to do
23 that. And the concerns that we have is that the efficiency
24 studies are prepared; but in our view, they are not
25 accurate, they are not what's really going to happen,

1 because people don't know what's going to happen.

2 So in some ways -- and this is strictly my
3 personal opinion -- the efficiency studies are fiction; and
4 yet a lot of stock is put on those, a lot of value is put on
5 those. They are reviewed by outside reviewers who may or
6 may not understand what's going on in the industry. They
7 are prepared by groups such as ours that essentially become
8 what are really realistic or hopefully realistic planning
9 documents. But they really are not what they are touted to
10 be. At least this is the view of all the people that we
11 have worked with.

12 In addition, there's no monitoring program. To my
13 knowledge, the federal government has no follow-up
14 monitoring program on efficiency studies. I've never seen
15 it take place. I see greatly detailed, massive volumes of
16 efficiency studies; and, yet, I don't know of any instances
17 where the federal government has come back in two years and
18 said, well, did you do what you said you were going to do?
19 But it's a good thing they don't, because they don't do what
20 they say they are going to do. They can't. They can't
21 possibly know.

22 So that, I think, is a very serious problem.

23 There's also a whole cult of organizational people
24 that are involved in this activity. And I guess that my
25 firm would be one of them. There are consultants like us

1 who prepare efficiency studies. There are -- every law firm
2 has -- every major law firm in this country that deals in
3 antitrust has someone who is an expert in how to put these
4 efficiency studies together. You hire economists, every --
5 the first thing a law firm will tell you is you've got to go
6 hire an economist that can help you put this together. And
7 the principal source of that are former employees of the
8 Justice Department who are the so-called experts in it.
9 There are private reviewers, and there are contract
10 reviewers that are outside.

11 So there's a whole little cult that's involved
12 with the efficiency studies; and, in our view, they aren't
13 effective.

14 I hope I'm not being too blunt here today.

15 Does that mean that I am, Debra?

16 MS. VALENTINE: No, no. You are absolutely right.

17 MR. PITTS: Well, I think that there needs to be
18 some process that is appropriate to determine if there is,
19 in effect, a meaningful reason to do a merger or
20 consolidation.

21 I think the process that is in place today is
22 fiction. I don't think it works as far as hospitals are
23 concerned. I don't know about anything else except
24 hospitals. But as far as hospitals are concerned, it
25 doesn't work. So you need some review. Possibly you could

1 have a process that would be worthwhile at a later stage in
2 the merger process; but at the point that you require it to
3 be done, it can't be done. No one knows those answers, and
4 so they make them up.

5 So there's no basis, really, in reality to the
6 efficiency study; and it's too detailed for the point in
7 time for which it's required.

8 Now, if you phased it in some way and dealt with
9 it in a macro level and if you had a more interactive
10 process -- perhaps teams of people -- I realize your
11 constraints on employees and how many mergers there are and
12 so forth -- but perhaps if you had some teams of folks from
13 your operation and from the Antitrust Division that could
14 work on an interactive basis to make -- just to determine if
15 it makes sense for the community and if it is or is not
16 going to be anti-competitive.

17 I can pretty much tell you -- of course, I've
18 spent all my life in hospitals -- but I can tell you pretty
19 much by walking into a community and looking at the
20 utilization information and talking to four or five people
21 whether or not it's going to be a competitive or an
22 anti-competitive merger or not. And you can quickly
23 determine that if you understand the industry.

24 But you can't determine it from an efficiency
25 study, not the way it's presently constituted now. So it's

1 a game. And a lot of us are involved in helping you play
2 the game.

3 So I hope I haven't been too blunt with you, but
4 it's very seldom that I get an opportunity to say what I
5 really think to someone. And so I hope I haven't over
6 stepped my bounds in doing so.

7 CHAIRMAN PITOFSKY: Certainly not. That's the
8 kind of testimony we want to hear.

9 But let's expand on it a little bit. You say that
10 you can walk into a community where there are three
11 hospitals, all three at 50 percent capacity, 50 percent
12 empty beds, and you can have a sense of whether or not the
13 merger is going to be good for the community or not, but
14 that somehow the information that's provided to the agency
15 is unreliable and not accurate.

16 Well, what is that you look at that perhaps we
17 ought to look at?

18 MR. PITTS: Well, I suppose it's where you depart
19 from science and get into art; and it's very difficult to
20 describe how that's -- how that takes place.

21 If you work in the health care industry every day,
22 as I have all my life, I can pretty much go into any
23 community and tell you, in rank order, each hospital in that
24 community and tell you which is a good quality institution
25 and which is not a good quality institution.

1 Now, there are thousands and thousands of bits of
2 information that go through your mind when you're trying to
3 do that. But I would suggest to you that if you would take
4 a half a dozen people similar in background to mine and we
5 made a secret list, we would all come up with pretty much
6 the same thing. And you can tell from the quality. And,
7 yet, if you say, how do you measure quality, either you get
8 very scientific in that or you do it at a very macro level.
9 It's very difficult.

10 But from a competitive standpoint, if -- there are
11 so few competitors in the hospital business; so the
12 Herfindahl-Hirschman index, for example, in my view, is a
13 good index where there are a lot of competitors in the
14 marketplace. I don't think it's good in a local hospital
15 marketplace because there are so few competitors.

16 If you can define the market, as I'm sure the
17 fellow from GE -- GM defines his market, as a national
18 market, at least then you can apply a series of indexes
19 there and look at it a lot differently.

20 Health care is a very regional, local, cottage
21 industry. It is not a national marketplace. And there are
22 many folks, myself included, who think that it's
23 inappropriate for it to be publicly traded. We believe that
24 when that happens that the community loses its control of
25 its assets in those areas.

1 So I can't give you a scientific answer to it, but
2 there are ways to do this on a macro level that
3 professionals can do that would be much more effective than
4 what we consider to be a game.

5 CHAIRMAN PITOFSKY: Let me -- I'm very sympathetic
6 with your notion that it's hard to judge efficiency claims
7 before the transaction takes place and that you would be
8 better off looking at them several years later.

9 The problem for us, I'm sure you understand, is we
10 almost have to make the call at the front end because, if
11 the solution to the problem is to close down one hospital
12 and transfer staff and equipment to the other hospital, for
13 us to come along two years later and say, well, the
14 efficiencies aren't as great as you want. It's very costly
15 in social terms.

16 So we're back to the front end, before the merger
17 takes place. Is this fair to say, that many efficiencies
18 are ephemeral or elusive, hard to quantify but some are not.
19 And, for example, if the claimed efficiency is that there
20 are just three hospitals and we only need two and we're
21 going to close down one of them as a result of a merger and
22 we're going to reduce the number of CAT scans and we're
23 going to reduce the number of MRIs, are not those
24 efficiencies measurable before the transaction?

25 And then let me just finish the thought. And then

1 perhaps we ought to disregard the kind of vaguer
2 efficiencies that are sometimes asserted?

3 But are there not some efficiencies that are
4 accurate and that we can rely upon?

5 MR. PITTS: Let me try to explain the difficulty
6 in what you say because what you say is absolutely correct.

7 In fact, I believe most of the efficiencies are
8 measurable. It's a question of when they are measurable.

9 Now, if -- and right now we're involved in
10 facilitating a merger of two of the largest hospitals in the
11 nation into one. It would be, essentially, the biggest
12 merger that's taken place in the country in the
13 not-for-profit sector.

14 We could sit down and say, you don't need two
15 major, regional cancer centers; you need one. So you take
16 out one or you consolidate them, and here's what you can
17 save and so forth. And that seems to be a very logical
18 thing to do.

19 We can't say that. If you talk about those -- you
20 can't get at the information unless you talk to the people
21 that are involved. And unlike for-profit activities where
22 you have control over those resources, you don't have
23 control over those physicians. You don't have control over
24 the community.

25 And if we went in and announced: We're going to

1 take out one cancer center; and we're going to have one open
2 heart program instead of two; and we're going to put all
3 pediatrics here; and we're going to have all deliveries done
4 there and only one high-risk delivery unit, instead of
5 multiple high-risk delivery units; and, therefore, we will
6 take out 2,000 employees, then the public sector that we're
7 dealing in -- and everything is completely open in this type
8 of situation, when you don't have control of the physicians
9 and you have voluntary boards that are making these
10 decisions -- you would never get the -- the deal will never
11 come down. It absolutely would not come down.

12 And so what you are left to do is to prepare an
13 efficiency study in the dark. If you do it any other way,
14 you'll lose the deal. You don't have control of the
15 shareholders.

16 I sit on a major regional bank board. When we
17 acquire a bank, it's very clear what that bank's worth. We
18 figure out what its value is, and we know how many shares
19 there are. And every person sitting there that's making a
20 decision knows, I own so many thousand shares; therefore,
21 I'm going to get this much money, and this is what's going
22 to happen to me. And that's very clear.

23 That's not true in a not-for-profit health care
24 delivery system because, who owns that activity? You can't
25 assign ownership. The community owns the activity. Who is

1 the community? And so who makes that decision? And so, if
2 you say, we're going to cut 2,000 people or 3,000 people or
3 we're going to cut back on this and that, it's a huge
4 complex. It's -- usually the biggest employer in the
5 communities we go into is the health care people.

6 So you lose your ability to cut the deal. You
7 lose the transaction because of the efficiency study, and so
8 you have to do it in the dark.

9 So it's different. I mean we know what the
10 efficiencies will be, but you can't get at the people who
11 have to help you put that together to make it or you'll lose
12 the deal.

13 It's a very complex problem for us.

14 CHAIRMAN PITOFSKY: Yes, it is. Thank you.

15 Mary?

16 COMMISSIONER AZCUENAGA: First of all, I
17 appreciate your candor.

18 MR. PITTS: Well, if I worked for Saturn or
19 someone like that, I couldn't do that.

20 COMMISSIONER AZCUENAGA: I understand.

21 I would like to clarify -- or to have you clarify,
22 if you could, what your recommendation is to us.

23 Do you think we should just not bother to consider
24 efficiencies when we look at hospital acquisitions in terms
25 of deciding whether to prosecute to prevent the acquisition

1 from going through?

2 MR. PITTS: Well, I wouldn't pretend to have the
3 expertise to advise you on that. But I think that the
4 process that you're now using needs to be changed in some
5 way. I think, perhaps, a more macro process instead of such
6 a micro process.

7 I don't know at what level the Commissioners are
8 involved with these activities; but if you have not seen a
9 hospital efficiency study, you should look at one, because
10 it goes into each department, individually, and it says,
11 we're going to take out a nursing supervisor at this level
12 and she makes \$45,000 a year and her benefit structure is
13 this and so forth. It goes into that minute detail, and
14 there is no way that anybody can do anything except make
15 that stuff up.

16 We're in a situation right now, two hospitals,
17 this is a three-hospital town, we were just engaged. We are
18 engaged -- these folks came in and the second hospital and
19 the third hospital in terms of size in the community decided
20 to consolidate.

21 They put together an efficiency study that takes
22 each FTE, full-time equivalent, position in an institution
23 and said, here's how we're going to put -- we're going to
24 move this department from that site to this site; we're
25 going to save -- we're not going to buy these pieces of

1 equipment because they can blend the pieces of equipment
2 together.

3 It's been cleared by the Justice Department. They
4 have heart Hart-Scott-Rodino approval. They have IRS
5 approval.

6 They called us in because the physicians are in
7 total, open rebellion in which they said, there is no way
8 that we're going to move all of our heart activities to this
9 site; nobody talked to us about this; we will never do that.

10 The boards have said, we've got to listen to our
11 physicians.

12 The whole deal is practically off at this point.
13 It's our job to go in and try to save it. But you should
14 read the efficiency study. And it is fiction, absolute
15 fiction, not real.

16 COMMISSIONER AZCUENAGA: Well, that's very
17 illuminating. I will say that we do look at them very
18 critically, at least that's been my experience.

19 MR. PITTS: And you use outside reviewers to look
20 at them. And people like me negotiate with those reviewers
21 on the telephone, and we say, oh, yeah; well, maybe that can
22 only be two FTEs instead of three.

23 And what we're doing is hopefully realistic
24 planning as to what might happen at some point, but it's not
25 what's going to happen. That's the difference.

1 So you need a more macro approach to it. I think
2 your approach works very well where you can assess ownership
3 and you have control over the resource and the assets. But
4 it doesn't work in a not-for-profit setting where you don't
5 have control of those -- the principal resources.

6 MS. DeSANTI: In terms of a more macro approach, I
7 was struck that -- and the 14th Street Bridge traffic may
8 have prevented you from hearing about this -- but one of the
9 points that Mr. Augustine made when he was in earlier was
10 that in defense transactions where you can sometimes run
11 into similar problems of, you're pretty sure there are going
12 to be efficiencies, but you don't know what those are or
13 what the values will be until you actually are able to put
14 the companies together. One of the things that defense
15 companies have done is to, in essence, set up some sort of
16 fund whereby their future payments from the Department of
17 Defense are payments supposed to come from cost savings that
18 result from a possible acquisition; and if those cost
19 savings don't occur, then their payments don't occur.

20 MR. PITTS: Yes.

21 MS. DeSANTI: Is there any kind of analogy in
22 health care that might be a similar sort of, well, put your
23 money where your mouth is; show us that you really do
24 believe that there are going to be these kinds of cost
25 savings that will accrue from this merger or acquisition,

1 rather than some sort of increase in market power that would
2 ratchet up the prices for everyone?

3 MR. PITTS: Yes, I did hear what he said; and I
4 thought it was an excellent idea. And I think it's
5 applicable to health care as well. I don't see any reason
6 why you can't say or even commit to a level of savings.

7 But trying to ask folks to identify that in
8 advance cannot be done. In the situation we're in right
9 now, we're talking a billion dollar -- two hospitals that
10 will have a billion dollars in net revenue on an annual
11 basis. We can tell you pretty quickly how many millions of
12 dollars can be saved by consolidating those. And those
13 become management targets, and there's nothing wrong with
14 doing that. But you need a follow-up procedure to do that.

15 What I'm just talking about, you know, if the
16 Justice Department went into the place where we are and
17 said, okay, what's happened a year later now and after your
18 efficiency study, they would find nothing has been done. To
19 the best of my knowledge, there's no follow-up at all on
20 that.

21 So I would suggest to you that you put in macro
22 levels of savings as a realistic basis, done by professional
23 people who can tell pretty much what that is going to be,
24 commit the organization to doing that, as you suggest in
25 which they will be penalized if they don't achieve those

1 levels of savings; and then have some follow-up mechanism in
2 a regulatory fashion in which you can determine if they did
3 it or not.

4 I noticed -- excuse me one more moment. I noticed
5 the -- Minnesota has a follow-up program now on a recent
6 merger that took place two years ago; and every six months,
7 the attorney general's office requires the folks to come
8 back in and to show whether or not they did what they said
9 they were going to do when they gave them approval for a
10 large merger in Minneapolis. That makes sense to me.

11 MS. DeSANTI: Let me ask you this: Are there
12 auditing procedures that would allow someone to go back in
13 and see, in fact, whether a million or more accrued in
14 savings? Or would we simply, then, get into cost accounting
15 studies that were just as much fiction as the studies that
16 you're talking about?

17 MR. PITTS: No. I don't think you would at all.
18 You know, one thing that is pretty clear in the hospital
19 industry since Medicare started is the accounting
20 procedures. That is my opinion, and I'm on the boards of
21 several institutions in other industries. It's better done
22 than the other industries are.

23 So I would suggest to you that that could be
24 easily identified and without getting into a lot of
25 controversy.

1 MS. VALENTINE: Just a quick follow-up question.
2 Do you happen to know what the consequences or penalty will
3 be in the Minneapolis example if the savings are not
4 realized?

5 MR. PITTS: No, I don't. I have never asked. I
6 have talked to the CEO that is the fellow who has to comply
7 with those activities, and he's not at all alarmed about it.
8 He think it gives him some additional leverage to continue
9 to effect the change in his organization that he needs to
10 do.

11 So at this point, there haven't been any
12 penalties because they're making -- they're living up to
13 their commitments. And I think that's a pretty good idea.

14 But, you know, the problem, as I see it, is that
15 all the resources in health care are essentially health in
16 trust by the community. And it is -- unlike any other
17 nation, our health care system has risen up from the
18 grassroots to take care of the needs in the community.

19 And you have to somehow balance the continual
20 effect of overseeing that trust responsibility with a
21 regulatory activity. But the two have to blend together in
22 some way that makes sense for the community.

23 And the efficiency study that you require now just
24 doesn't do that.

25 CHAIRMAN PITOFSKY: Well, thank you very much for

1 a practical, very unvarnished view of these efficiency
2 claims. We appreciate your coming.

3 MR. PITTS: Thank you for having me.

4 CHAIRMAN PITOFSKY: I guess we will adjourn at
5 this point and resume at 1:30.

6 (Whereupon, at 12:00 p.m., the hearing was
7 recessed, to reconvene at 1:30 p.m., this same day.)

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1 unit. In '93 and in '94, she received the Assistant
2 Attorney General's Award for Outstanding Achievement. And
3 from '85 to '93, prior to coming into government service,
4 she was an associate and then later a partner at her current
5 law firm.

6 Ann.

7 MS. JONES: Thank you very much.

8 I would like to thank the Commission for an
9 opportunity to address some practical aspects of evaluating
10 the efficiencies defense in Section 7 merger review.

11 While the 1992 Horizontal Guidelines have
12 concluded that some consideration should be given to claims
13 that efficiencies obtained from a proposed acquisition will
14 have the net effects of enhancing competition and consumer
15 welfare, less has been written regarding precisely how
16 antitrust enforcers should evaluate such an efficiencies
17 defense.

18 Some critics have rejected case-by-case
19 consideration of efficiencies altogether because of the
20 difficulties and complexities of weighing the probability
21 and magnitude of claimed efficiencies. Others faced with
22 the daunting task of sorting through thousands of documents
23 and dozens of interviews to discern whether the claimed
24 savings to the merged firm outweigh the anticipated
25 anti-competitive consequences of increased market power,

1 have proposed limiting the defense to certain enumerated
2 efficiencies or permitting it to be asserted only under
3 certain market conditions.

4 I agree with those who argue that some limitation
5 on the scope of permissible efficiencies defenses is
6 necessary to facilitate a predictable and reasonably
7 expeditious resolution of merger inquiries.

8 Rather than enumerate the nature of the
9 efficiencies that should be considered or discuss the
10 structural features of markets in which an efficiencies
11 defense should be allowed, I would like to posit an
12 alternative analytic approach, one which promises to
13 simplify the process of examining claimed efficiencies
14 without losing the benefits of being flexible and capable of
15 accommodating dynamic markets.

16 My alternative approach is derived largely from
17 the existing method by which courts assess claims by a
18 monopolist that its exclusionary refusal to deal is
19 justified by legitimate business reasons.

20 As with the efficiencies defense, the defense of
21 legitimate justification arises in the context of an
22 otherwise illegal transaction, one which, if not excused,
23 will violate antitrust laws. The legitimate justification
24 defense must be asserted and proved by the defendant to be,
25 first, legitimate; it must enhance competition for the

1 benefit of consumers and not be pretextual. There must be
2 contemporaneous and sufficient evidence to permit a
3 reasonable inference that the defendant's asserted
4 justification in fact motivated its exclusionary conduct.

5 My view is that, to establish the efficiencies
6 defense, the merging parties bear the burden of proving the
7 same elements required to establish the legitimate
8 justification defense.

9 Applying the business justification paradigm to
10 the assessment of merger efficiencies has several pluses.
11 First, the defense is directly correlated to the underlying
12 purposes of the antitrust laws. Second, it permits a full
13 and fact-based inquiry into the likelihood that the
14 efficiencies will be achieved and rejects pretextual claims.
15 And, finally, it avoids the difficulties of quantifying
16 efficiencies by affording an absolute defense in relatively
17 unconcentrated markets.

18 Taking each one of these points individually:

19 Under the first prong of this proposed approach,
20 the only efficiencies that could be considered are those
21 that can be predicted to enhance competition in the
22 concentrated market at issue.

23 Under this test, certain efficiencies claims, such
24 as those citing improved competitive performance from a
25 merger of firms with closely related products or

1 complementary production processes -- would be considered
2 because they have the potential for lowering costs,
3 stimulating rivalry, improving allocation of resources, and
4 ultimately benefiting the competitive process.

5 Other claims of efficiencies, for example,
6 pecuniary efficiencies such as tax savings, that do not
7 result in enhanced competition would not be cognizable. Nor
8 would those efficiencies, such as improvement in managerial
9 expertise, that can be accomplished by means far less
10 restrictive than acquisition, be allowed.

11 Efficiencies defenses that cannot be traced to
12 enhancing competition in the affected market should be
13 rejected.

14 This requirement that efficiencies defenses be
15 related to the underlying purposes of the antitrust laws to
16 promote competition and benefit consumers is consistent with
17 the Clayton Act's legislative history.

18 A requirement of consumer benefit does not,
19 however, mandate proof that all of the claimed savings will
20 inure to customers in the form of lower prices. Such a
21 requirement would, in most cases, vitiate the defense.

22 While some efficiencies may lower production costs
23 affording an otherwise inefficient firm an opportunity to
24 compete more vigorously with the remaining competitors,
25 others may translate into unchanged costs producing a better

1 product or a product that affords the public benefits by
2 offering an entirely new quality/cost combination that
3 consumers prefer over previous offerings.

4 Improved quality or the development of new
5 products is an element of competition and is beneficial to
6 consumers, even though prices post-merger remain unchanged.

7 Unlike an approach that simply lists acceptable
8 efficiencies, the standard I have discussed for legitimate
9 efficiencies defenses affords parties and the agencies
10 latitude to consider new or innovative, but nevertheless
11 valid, claims of possible savings afforded by a merger.
12 Moreover, this standard evaluates claimed efficiencies in
13 the context of dynamic market conditions and not in
14 isolation.

15 But the test of legitimate justification is not
16 infinite. It is limited by the well-established purposes
17 and goals of the antitrust laws. Not only is there merger
18 law upon which practitioners and enforcers could rely to
19 ascertain whether a claimed efficiency defense was legally
20 cognizable, there are hundreds of decisions derived from the
21 larger body of antitrust law -- for example, cases deciding
22 questions of antitrust injury, the application of the rule
23 of reason or cases involving legitimate business
24 justification -- that can be applied to ascertain whether a
25 claimed efficiencies justification is, as a matter of law,

1 legitimate.

2 The second prong of this proposed efficiencies
3 methodology asks whether the alleged benefits of the merger
4 actually motivated the acquisition or whether they are
5 "assumptions, overstatements, and speculations offered by an
6 interested party who has control of the supporting
7 information." Described in monopolization cases as testing
8 whether the claimed defense is pretextual, this prong of the
9 analysis asks whether the documents and contemporaneous
10 statements of the party to the merger support their claims
11 of anticipated efficiencies.

12 Assessing pretext is something that is frequently
13 performed in antitrust litigation. Contemporaneous business
14 records provide a relatively reliable source for testing the
15 plausible efficiencies asserted in defense of a merger.
16 Where, for example, none of the executives participating in
17 the merger mention, discuss, or identify claimed
18 efficiencies in their analysis of a particular acquisition,
19 it is appropriate to discount the claim when asserted before
20 the Commission.

21 As an example, one indicator of pretext is a
22 prediction that some or all of the claimed efficiencies will
23 not materialize. Certain facts may make it more reasonable
24 to conclude that the incentives to realize claimed
25 efficiencies may be diminished once market power is

1 attained.

2 For example, in its decision rejecting AMI's
3 acquisition of French Hospital in San Luis Obispo,
4 California, the Commission cited several facts in rejecting
5 AMI's claimed efficiencies defense. Difficulties in the
6 actual consolidation of hospital operations due to state
7 regulatory impediments, the significant capital expenditures
8 required to accomplish facility consolidation, and the
9 statements of uncertain savings contained in the memos of
10 corporate executives supported the conclusion that the
11 savings claimed before the Commission were unlikely to be
12 realized.

13 I do not believe that it is necessary to add
14 conditional clearance or other post-hoc remedies, to winnow
15 out pretextual claims of efficiencies. In fact, in many
16 cases, such a decree may have the effect of creating a
17 powerful incentive for parties to manipulate post-merger
18 documents to create a defense that never truly existed.
19 Courts have consistently viewed post-merger assessments of a
20 party's motivation or behavior with appropriate skepticism.

21 The creation of a false record of savings will not
22 only defeat the underlying purpose of post-merger
23 monitoring, it will mislead courts in later filed cases in
24 which private parties or states sue to challenge the
25 legality of a particular merger.

1 Rather than reducing the number of pretextual
2 efficiencies, a conditional clearance may have the perverse
3 effect of inviting the manipulation of post-merger evidence
4 to support nonexistent savings.

5 One of the oft-cited objections to the
6 consideration of efficiencies in merger analysis is the
7 enormous difficulty of performing a trade-off between
8 efficiencies and anti-competitive effects.

9 Quantifying the magnitude of claimed efficiencies
10 and then using those savings to offset the predicted harm
11 from increased concentration is overwhelmingly difficult.
12 In all but the most conventional of efficiencies claims,
13 such as economies of scale, there is little empirical
14 evidence -- either in industry studies or in the actual
15 business records of the merged entity -- to justify a
16 reasonable estimate of the actual savings to be realized by
17 consumers. To require such proof is to extinguish the
18 defense.

19 As an alternative, I would propose a much broader
20 balancing, one that restricts the defense to those markets
21 in which we can predict that efficiencies are capable of
22 outweighing the anti-competitive consequences of increased
23 concentration, but that does not require an absolute
24 quantification of that proposition.

25 One such approach would be to allow a defendant to

1 assert a substantial, competition-enhancing savings unique
2 to a merger that will inure, in some part and in some
3 fashion, to consumers as a complete defense where
4 post-merger concentration was moderate.

5 Where, however, the merger resulted in highly
6 concentrated markets, I would argue that no efficiencies
7 will obtain savings of sufficient magnitude to offset the
8 likelihood of adverse consequences for consumers. In such
9 cases, therefore, no efficiencies defense should be
10 permitted.

11 Until recently, much time and effort have been
12 expended in deciding whether an efficiencies defense should
13 be considered in merger analysis. Because that issue has
14 been resolved, increased attention is now being directed at
15 the particular method by which such evidence will be
16 considered. Into this debate, I submit a possible model for
17 your consideration. It has the benefit of being tested and
18 used in actual antitrust litigation and will afford working
19 antitrust attorneys a known approach that can be adjusted
20 for the needs of merger analysis as experience requires.

21 Thank you very much.

22 COMMISSIONER STAREK: Well, thank you. There were
23 certainly some concrete proposals there and ones which I
24 think will be the subject of our discussion and debate and
25 questions after all of the witnesses have given their

1 prepared remarks, if that's all right with the panel.

2 Our next speaker this afternoon is Jim Egan. Jim
3 is counsel with the Washington, D.C., office of Rogers &
4 Wells.

5 And from 1990 to 1994, Jim served as the Director
6 for Litigation in the Bureau of Competition here at the FTC,
7 during which time he was heavily involved in the drafting of
8 the 1993 and 1994 Statements of Antitrust Policy in the
9 Health Care Area.

10 Before he served as the Director for Litigation,
11 Jim was an Assistant Director in the Bureau; and he's worked
12 at the FTC since 1971, prior to his unfortunate departure
13 from our ranks in 1994. He probably doesn't look at it that
14 way, but we do here.

15 Jim?

16 MR. EGAN: It wasn't a departure. It was a
17 retirement. I would like to keep that distinction.

18 As I walked in this room where I have spent a lot
19 of time over the years, I could hear some echoes from years
20 past where I was pounding the table and saying:
21 "Efficiencies don't count." But, obviously, we are past
22 that point.

23 COMMISSIONER STAREK: I'm told that when people go
24 into private practice, they take different views of these
25 matters.

1 MR. EGAN: Somebody questioned me about that out
2 in the hallway, and I said -- about being on the other side.
3 And I said: No, I'm here in the public interest, as always.

4 But, at any rate, as I read the questions that
5 were posed here and thought about this and thought what do I
6 have to bring to bear to this? Because obviously there are
7 people who are more academically inclined than I am and can
8 get into these things from an academic point of view.

9 What do I have to bring to this? And I do have
10 that -- the experience at the FTC over all those years where
11 I did see probably as many efficiencies defenses argued as
12 probably anybody in this room, I suspect, and heard them.
13 And we did argue early on about whether or not efficiencies
14 even counted at all, and we didn't get into so much -- how
15 much they should count or how they should be analyzed.

16 The one starting point here, it seems to me, is
17 that for all of the efficiencies defenses that have been
18 presented at the agencies over the years, there have been
19 very, very few that have been dispositive in terms of merger
20 analysis.

21 And, nevertheless, there has been a great many
22 resources, perhaps inefficiently, spent on the question of
23 efficiencies, at the Commission level in deciding whether or
24 not to pursue a case once we've gotten into the court,
25 presenting the case to the court and having a, quote,

1 efficiencies defense presented and all of the complicating
2 -- and it is a complicating issue. It's an issue which, for
3 the most part there are no ground rules as to what can or
4 cannot be used to establish efficiencies.

5 So in a lot of cases, I would say half the record
6 was taken up by the efficiencies defense. And at the end of
7 the day, what do we have? We had the court or the
8 Commission shrugging aside the efficiency defense, not
9 really articulating why but being left with a situation
10 where it really couldn't take these factors into account in
11 any sound way, that it didn't have a methodology for doing
12 so. And it didn't have a methodology for saying why they
13 didn't count.

14 And I guess that leads to me to conclude that
15 maybe there is some more guidance that's needed. And I
16 think the suggestion that has just been made is consistent
17 with my own thoughts. And that is that there is not or
18 should not be an efficiency defense. I think the Merger
19 Guidelines read carefully suggest that that's the case, that
20 it's not a defense, that it's just part of the analytical
21 process of determining whether or not a merger lessens
22 competition or not.

23 And what, I think, further step needs to be taken
24 now perhaps is a further articulation of the Merger
25 Guidelines to lay out the analytical model -- and I think

1 that's what's been suggested here -- to lay out the
2 analytical model and to set forth how efficiencies will be
3 integrated into the analysis.

4 And I don't see any reason why that model isn't
5 essentially the same under the rule of reason -- merger
6 analysis as in the rule of reason, horizontal restraint
7 analysis; and that the ultimate question that should be
8 posed is: At the end of the day, is the transaction going
9 to benefit competition, taking into account all factors,
10 including efficiencies, or is it going to lessen
11 competition? At the end of the day, are the consumers going
12 to have more choices or fewer choices, better choices or
13 less better choices? And I think efficiencies are properly
14 considered in that context.

15 If it's taken the step further that I think a lot
16 of practitioners believe that it is taken, that they are
17 under the perception that the Commission views the
18 efficiencies -- consideration of efficiencies as a defense,
19 that's where I think we run into problems, because then -- I
20 gave a couple of examples in my written presentation -- then
21 you run into situations where -- where factors that I think
22 are obviously not or should not be cognizable efficiencies
23 are litigated are offered, and we spend a lot of -- waste a
24 lot of time about that.

25 And the example was in the University Health case.

1 And, there, one of the arguments -- there were three
2 essential efficiencies arguments. One of the essential
3 efficiencies arguments was that the hospital to be acquired,
4 St. Joseph's, was about to embark upon an expansion program.
5 It was going to build a women's center. And the argument
6 was, the market doesn't need another women's center; and
7 we're going to do this acquisition; and that will be an
8 efficiency because we will prevent those resources from
9 being devoted to the women's center.

10 And if traditional joint venture analysis was
11 applied to that, I think we would get the answer that the
12 Supreme Court gave in National Society of Professional
13 Engineers, that it's up to the market to decide whether or
14 not another women's center is appropriate or not and that
15 all you're arguing is that competition, the decision of
16 competition, is wrong here. And that, it seems to me,
17 should not be a cognizable issue under an efficiency rubric
18 or anything else.

19 And I think it's important because if we could
20 have further guidance from the Commission and the Department
21 of Justice as to the model that was going to be used and it
22 did allow us to rule out those types of efficiencies, I
23 think it would save a lot of resources.

24 Let me just say a word -- because I do touch on it
25 in my paper as well -- on the issue of whether or not

1 efficiencies are difficult to prove. I mean, I think that's
2 just something that most people would not dispute.

3 Most efficiency defenses that I've seen presented
4 have taken the form of a laundry list. And some official
5 from the firm gets up and testifies that we are going to
6 have all of these savings. It's very hard to contradict
7 those laundry lists, other than to say all they are are
8 laundry lists. It's also very hard, on the other hand, for
9 the firm to come forward with proved savings because, after
10 all, they are trying to predict something that's going to
11 happen in the future. So it's hard from both sides, it
12 seems to me, to present solid evidence on that.

13 Now, what is that -- what's the implication of
14 that? In my view, the implication of that is two fold. One
15 is consideration of efficiencies, inclusion of efficiencies
16 into the equation is probably best done in the context of
17 cases that are otherwise on the margin, that it's very, very
18 difficult to include efficiencies in the equation other than
19 on that basis.

20 And the second aspect of it is, it seems to me
21 that it's a lot easier for the Commission or the Department
22 of Justice to consider efficiencies on what I would call the
23 softer basis of prosecutorial discretion than in a hard rule
24 of law that it applies in a case.

25 It's a lot easier for the Commission to look at a

1 case and say, well, this is on the margin and there are
2 certain factors which argue against bringing this case or
3 certain factors which argue in favor of bringing this case.
4 It's a lot harder to articulate with any kind of precision
5 that's going to send the kind of signal that you want to
6 send in a litigated case as to how efficiencies are weighed
7 in the process.

8 So in the end, my modest suggestion -- and I'm not
9 articulating it with as much specificity as the previous
10 speaker -- but my recommendation is that the Commission and
11 the Justice Department ultimately consider flushing out the
12 guidelines as it relates to -- as they relate to
13 efficiencies and making it clear what the analytical
14 framework is; and, therefore, it will allow both sides to
15 focus on what's truly relevant and to not get bogged down in
16 -- which is what's happened to date, I believe -- not get
17 bogged down in -- over issues that really shouldn't be
18 argued or litigated.

19 Thank you.

20 COMMISSIONER STAREK: Thank you very much, Jim.
21 That was extremely helpful. And based on all of your
22 experience in litigating these matters and in seeing the
23 parties raise these efficiency issues, it was very, very
24 helpful.

25 Our next witness this afternoon is Dale Collins.

1 Dale is a partner at the law firm of Shearman &
2 Sterling in New York City where he specializes in antitrust
3 defense of mergers and acquisitions.

4 Dale's practiced at Shearman & Sterling since
5 1978. In 1981, he left the law firm to work as a Special
6 Assistant to Vice President Bush and Deputy Counsel to the
7 Presidential Task Force on Regulatory Relief.

8 And after serving then-Vice President Bush, he
9 became the second ranking official in the Antitrust Division
10 of the Department of Justice until he returned to Shearman &
11 Sterling in 1983.

12 Since 1991, Dale has been an adjunct faculty
13 member at the Yale Law School where, surprisingly, he
14 teaches antitrust law.

15 MR. COLLINS: Thank you very much

16 COMMISSIONER STAREK: Thank you, Dale.

17 MR. COLLINS: I think it's -- it really is all too
18 infrequent that the enforcement agencies step back and
19 re-examine some of the bigger questions that are posed by
20 antitrust law.

21 I think it's particularly important that the
22 agencies do that outside the context of, you know, the
23 battle of particular matters, largely because the antitrust
24 law is supposed to be evolutionary. It was created to be
25 that way -- you know, from the time of the Sherman Act in

1 1890, and it continues to be so today.

2 But we have stepped away somewhat from the
3 traditional common law approach to antitrust law largely
4 because so few cases, particularly merger cases, are
5 litigated. The agencies, I think, really do need to step
6 back and think about some of the broader issues that are
7 presented; and I think that the Chairman and the
8 Commissioners here should be commended for these hearings.

9 I think efficiencies is one of the more difficult
10 analytical topics in merger antitrust law. And it's also
11 one of the most important ones, particularly in an era where
12 there are -- you know, we have so many markets in which
13 rapid technological innovation, changing cost structures
14 are, you know, so characteristic, we really do need to
15 figure out how efficiencies should figure into the antitrust
16 calculus.

17 The Supreme Court sort of set the tone of
18 efficiency analysis in Brown Shoe where it expressed more
19 than a small degree of hostility, I think, to efficiencies.
20 And that's been pretty much continued forward.

21 I mean when Don Turner wrote the 1968 Merger
22 Guidelines, he didn't take the, sort of the literal
23 hostility of the Brown Shoe court; but he did say
24 efficiencies, except in exceptional circumstances, would not
25 be considered.

1 That same notion was carried forward in the 1982
2 guidelines, the 1984 guidelines, and really the 1994
3 guidelines, where efficiencies were recognized as something
4 that, in some sense, might be important but probably only in
5 exceptional cases. And in those exceptional cases, the
6 guidelines didn't tell you how to handle them.

7 And I think therein lies the fundamental problem.
8 And this is really what Mr. Egan was saying.

9 Now, since the agencies really don't know what to
10 do or haven't developed a coherent framework on how to deal
11 with efficiencies, something's happened. So the fault
12 position, if you will, has emerged. And the default
13 position, particularly, I think as implemented by the
14 investigating staffs in both agencies, comes down around,
15 you know, one of three outcomes. They're not mutually
16 exclusive.

17 One is, if the evidence of the claimed
18 efficiencies are too speculative for them to be cognizable,
19 in the analysis they are basically rejected. Okay? On
20 grounds of cognizability. They haven't been established.
21 You don't have to figure out how to weigh them or anything
22 like that. You just don't think about them any more.

23 The second way that these analyses I think
24 typically turn out is that the claimed efficiencies to the
25 extent they exist are not merger-specific and, therefore,

1 somehow are not relevant to the analysis.

2 And the third way that efficiencies are typically
3 rejected is that the claimed efficiencies, to the extent
4 they may exist and are merger-specific, will not be passed
5 on to consumers and, again, are somehow irrelevant to the
6 analysis.

7 Now, I'm not suggesting at this point that those
8 conclusions are, you know, wrong generally. They may,
9 indeed, be right. But I think part of the question is: If
10 they are right, why are they right? And in order to
11 understand why they might be right, you need an analytical
12 framework for understanding what the role of efficiencies
13 should be in the first place.

14 I think the lack of an analytical framework in
15 which to assess efficiencies has encouraged the hostility
16 toward efficiencies that the agencies have historically
17 demonstrated. And that's true in the -- today, we recognize
18 that efficiencies is one of the purposes of the antitrust
19 laws, is to promote efficiencies in the markets.

20 Now, as I said, if real efficiencies do result
21 from a merger, they should figure in the analysis in some
22 coherent and sensible and, I would stress, transparent way.

23 This is not to say that evidentiary problems don't
24 exist. I think they do. But I don't think those
25 evidentiary problems are really qualitatively different than

1 the evidentiary problems we see in lots of other areas of
2 antitrust law generally and of merger antitrust laws. We
3 cope with them in other cases; we should cope with them
4 here.

5 Okay. Moreover, I suggest that the evidentiary
6 standards, both as to the allocation of the burdens of proof
7 and the quantum of the evidence necessary to discharge that
8 burden should flow from the analytical underpinnings of the
9 defense. And what we've done, sort of, was we put the cart
10 before the horse. You know, we have raised questions of
11 quantum evidence and questions of relevancy, cognizability,
12 without really understanding what the underlying -- you
13 know, the underpinnings of the defense are.

14 So what I would like to do, just in a couple of
15 minutes really, is to explore -- in about the simplest case
16 I can think of -- how one might think about an efficiencies
17 defense in one particular case.

18 Now, I want to stress going into this
19 hypothetical, one, that it is a hypothetical -- I've sort of
20 pulled out the facts, made them up as I've needed them --
21 and, two, that this is only one variant of the defense.

22 I think we should be careful -- hopefully, this
23 example will help point this out -- that there can be lots
24 of different kinds of efficiencies defenses. Okay? And
25 that it is really the job of the proponents of the defense

1 to tell the agency what their defense is supposed to do.
2 Okay? And then once they tell the agency how the defense is
3 supposed to work analytically, then the agency should be in
4 a position to examine whether or not the defense is, indeed,
5 you know, a valid defense in the context of that case.

6 So here's my hypothetical for you. It's real
7 simple. I'm going to take a relatively highly concentrated
8 industry. Let's say we've got five firms; the biggest firm
9 has 35 percent; second largest firm has 25 percent; the
10 remaining firms basically dwindle down to 10 percent. That,
11 by the way, will give you a pre-merger HHI of about 2300.
12 Well, nice and high.

13 And I want to have Firm Number 2 which is 25
14 percent, merge with Firm Number 5 which is 10 percent, which
15 would give you a change of 500. So we've got a 2300
16 Herfindahl index going to 28500, if I've done the math
17 right.

18 Now, these firms are engaged in the manufacture
19 and sale of residential circuit breakers. Now one of the
20 things that's interesting about residential circuit
21 breakers, or circuit breakers generally, is the way they are
22 designed is they are designed to contain a small explosion.
23 When the circuit breaker is triggered, a gap develops inside
24 the circuit breaker and a spark jumps over that gap, ionizes
25 the air, which causes this explosion. Okay?

1 A big part of the cost of the circuit breaker is
2 the box to contain the explosion. If you can figure out
3 ways to minimize the explosion, you can build boxes which
4 aren't as sturdy and, typically, don't cost as much. A big
5 portion of the cost of circuit breaker boxes is actually the
6 cost of the bake light that goes into them. Okay?

7 Now, in my little hypothetical, what we have is
8 we've got the top firms in the industry whose -- their
9 shares have been expanding, investing in cost-reducing R&D
10 to minimize the explosions that are going on in the circuit
11 breaker boxes; and we've got the smaller firms in the
12 industry not really engaged in that kind of research. Okay?
13 It could be a matter of choice, and it could have been a bad
14 mistake on their part not to do it; but they decided not to
15 do it in any event.

16 So the circumstances we're faced with in my
17 hypothetical currently is that we have the major firms with
18 significantly better technology in the sense that they can
19 build boxes cheaper on a per unit basis than the smaller
20 firms in the industry can and, in particular, the smallest
21 firm in the industry.

22 And the smallest firm in the industry, perhaps
23 again because of a mistake in its decisionmaking to invest,
24 it didn't -- now is running at very low levels of
25 profitability. That's high marginal costs. And it doesn't

1 have the wherewithal, really, to invest in additional
2 technology.

3 Firm Number 2 wishes to acquire Firm Number 5 and
4 give you this 500 change in the Herf. Okay?

5 How should you analyze that transaction? I mean,
6 how should you even begin to think about this? The parties,
7 of course, are going to argue that notwithstanding the high
8 market shares in this transaction, the transaction should be
9 allowed to go through because of the efficiencies. The
10 efficiencies, in particular, are that you can take the
11 technology from the large firm and drop it into the box of
12 the small firm at virtually no cost. Okay?

13 It's really -- it's intellectual property rights
14 as much as anything that's driving this. I mean, the
15 research and development has been captured in patents; and
16 you can take the patent technology and you can give it to
17 the manufacturing operations of the smaller firm and, almost
18 over night, significantly reduce the marginal costs of the
19 smaller firm.

20 So the question now is: How do you analyze this?

21 I would suggest the way to start, and you might as
22 well start at the beginning, right? in the beginning is the
23 prima facie case. Well, the prerequisite to any violation
24 of the antitrust laws is going to be some showing that there
25 will be an anti-competitive effect. And the guidelines tell

1 us in the merger case that the modern conception of this
2 anti-competitive effect is going to be the creation or
3 enhancement of market power as manifested in, likely higher
4 prices, reduced product quality, or reduced rates of
5 innovation. Okay?

6 Now, in horizontal merger -- remember, it's
7 important to keep that in mind that that's an essential
8 element of the violation, because what the defense is in
9 this case is going to turn on how it relates to that element
10 of the violation.

11 In horizontal merger cases, typically that element
12 is proved in the prima facie case by an appeal to a
13 presumption, the Philadelphia Bank presumption, which is
14 basically a device to take circumstantial, structural
15 evidence and conclude that the requisite anti-competitive
16 effect is present for the purposes of withstanding, say, a
17 motion to dismiss. Okay?

18 So let's assume we've got all that. I mean, the
19 Philadelphia National Bank presumption should be fairly
20 easily satisfied in this case. So -- and there's been a
21 motion to dismiss. And in my little hypothetical here,
22 we're going to draw this staged pleadings approach out as if
23 it were in court.

24 Motion to dismiss has been denied. Now turn over
25 to the defendants and say: Defendants, what do you have to

1 say? Okay?

2 Well, the first choice the defendant has to make
3 in articulating its efficiencies defense is it's got to
4 figure out what kind of a defense is it going to run?
5 Really, it's got two choices. It can run an affirmative
6 defense. That really is, as much as I can tell, is what
7 Ms. Jones was talking about.

8 And in an affirmative defense, what the defendants
9 are doing is they're saying: Yes, there's an
10 anti-competitive effect. But the anti-competitive effect is
11 justified because of these efficiencies.

12 There's another choice they could make. They
13 could say: We're not going to run this as an affirmative
14 defense. We're going to run it as a negative defense, that
15 there was not an anti-competitive effect to begin with.
16 Okay?

17 That the efficiencies vitiated the
18 anti-competitive effect from the beginning. Okay?

19 In more concrete terms, what they would say is
20 that the equilibrium price after the acquisition will be
21 lower than what it would have been before the acquisition,
22 even taking into account possible changes in the --
23 basically, in the slopes of the marginal revenue curve that
24 might yield some degree of, in some sense, increased market
25 power. But it's not going to be reflected in the

1 equilibrium price, at least it won't be reflected in the
2 sense that the prices will be higher. They'll be lower.
3 Okay?

4 So what I propose in this situation is that the
5 defendants want to run a negative defense. Now the
6 classifications of defenses -- I mean, if you look at this
7 as traditional lawyers, the classification of defenses is
8 important both economically and legally. Okay?

9 On the economics, an affirmative defense actually
10 calls for balancing of the anti-competitive effects -- say
11 the higher prices, the assumed higher prices -- against some
12 efficiency gains. And I think if you articulate it that
13 way, the sense that most people get is you've got an apples
14 and oranges problem. And they've never figured out how to
15 do the apples and oranges; and, therefore, they fall apart
16 on the analysis at that point. Okay?

17 And I'm not going to address the affirmative
18 defense version of an efficiencies defense here. I'm going
19 to take the simple case, again, take the negative defense
20 version.

21 Here, there's no balancing. Okay? What you're
22 doing is you're looking for the equilibrium. This is just
23 going to be higher or lower than it would have been in the
24 absence of the transaction. Okay?

25 That's a question that at least is a well-defined

1 question. And I could make this so we can talk about, you
2 know, changes in quality or rates of innovation and that.
3 But I'm only going to stay with prices in this simple little
4 industry.

5 Okay. Now those are the economic effects. Now
6 what about the legal effects. What are the legal
7 consequences of these classifications? Well, the legal
8 classification -- or the legal consequence really goes to
9 the burdens of proof. Okay? The allocations of the burdens
10 of proof. And typically -- traditionally, there are two
11 types of burden. There is the burden of going forward, and
12 there is the burden of persuasion.

13 Now, in an affirmative defense, typically both
14 burdens belong to the proponent of the defense. However,
15 traditionally in the negative defense, the burden of going
16 forward is allocated to the proponent of the defense; but
17 the burden of persuasion, once the burden of going forward
18 is satisfied, reverts to the -- well, to the plaintiff in
19 this case. Okay?

20 So, having said all that, two questions are
21 presented as we sort of go through this thing doctrinally.
22 And that is, number one, as far as the burden of going
23 forward is concerned -- which is going to rest with the
24 defendants -- what is the quantum of proof necessary to
25 discharge the defendant's burden of going forward? Okay?

1 Question Number 2, for the negative defense, is:
2 Is the traditional allocation of the burden of persuasion
3 properly placed on the plaintiff; or should it be reversed
4 in this case and placed on the defendants? Okay?

5 Now, let's address the question: What is the
6 quantum of proof necessary to discharge the defendant's
7 burden of going forward? Okay.

8 Well, remember, the essence of the prima facie
9 case was that market power would be exercised and manifested
10 in higher prices. So if you're going to attack that, you're
11 going to -- what you're, in effect, saying as the defendant
12 is that the prices won't be higher; they'll be lower; or at
13 least they won't be any higher than they would have
14 otherwise. Okay?

15 Now, how did the plaintiff prove that the, for
16 this prima facie case, that the prices would be higher?
17 Well, you appeal to a structural presumption, the
18 Philadelphia National Bank presumption, which basically
19 tells you something about directions, perhaps, of price
20 movements but nothing about quantity or the size of the
21 price movement itself.

22 So I would submit that the level of proof, the
23 quantum of proof that you need in order to discharge the
24 burden of proof of going forward -- the burden of going
25 forward is simply enough to raise a genuine issue of fact

1 that the price direction may be downward as a result of the
2 transaction and not upward. Okay?

3 And in my little case, you'll see how that works
4 without any problem; because, in fact, what happens is you
5 shift the marginal costs of manufacturing the circuit
6 breakers down. And when you do that, if you assume that
7 there's no change in the marginal revenue curves, prices
8 will, in fact, go down. Okay?

9 So I've got enough evidence now to discharge my
10 burden of going forward.

11 So, that's the burden of going forward. Now we go
12 to the hard question, and that's the burden of persuasion.
13 Should it revert to the plaintiff, or should it stay with
14 the defendant?

15 If it goes to the plaintiff, the plaintiff must
16 show by a preponderance of the evidence that the post-merger
17 equilibrium price will go up. Okay?

18 Now, in the first instance, that's going to
19 require that the plaintiff demonstrate that there's some
20 upward pressure on price. Okay?

21 And I think here is where one of the big problems
22 in efficiencies analysis comes in. And that is, very
23 seldomly do the agencies -- or any plaintiff -- really think
24 about the model of what the nature of the upward effect on
25 price is going to be. They stop with the qualitative

1 conclusion that the pressure is upward. But I don't think
2 you can stop there if you're trying to do an efficiencies --
3 if you're trying to analyze the efficiencies where you've
4 got some reason to believe that there are also some gross
5 downward pressures in price.

6 Now, I would argue to you that the allocation or
7 the burden of persuasion is properly placed on the plaintiff
8 in this case. Okay? And the reason for that is you are
9 basically asking the plaintiff to establish what is the
10 essence of its case of a violation, and that is the
11 anti-competitive effect.

12 I think also the plaintiff is in a better position
13 to prove or to develop a theory as to how the price
14 increasing effect might work. So I would urge that the
15 traditional allocations of the burden of proof for negative
16 defenses be preserved in this case.

17 Okay. Now I do have a qualification to that. And
18 that is that, to the extent that the defendants are in the
19 best position to quantify the changes in the marginal costs,
20 they should not benefit from any uncertainties in their
21 quantification. But overall, the burden of proof -- the
22 burden of persuasion should remain on the plaintiffs, not on
23 the defendants.

24 Okay. Now, if you take that -- let me just finish
25 this up real quick. If you take that as the -- sort of a

1 traditional burden of proof analysis for a negative defense,
2 it's got some consequences for the way that efficiencies
3 appear to be analyzed, at least at the investigating staff
4 level. And the first one I'd like to talk about is: What's
5 the requirement of merger specificity? Okay? Where does it
6 come from if you adopt the negative defense perspective that
7 I just put forward.

8 And the answer is, you're not going to find it
9 there. At least, you're not going to find it generally
10 present, because the only question is whether or not the
11 prices are going up or going down. And the question of
12 whether or not they could have been obtained in another way,
13 which is usually the way the merger specificity requirement
14 is asked, is basically irrelevant. Okay?

15 Now, I do have an exception to that. And that is
16 -- and this goes back to the would/could distinction that
17 we're all so fond of in the guidelines.

18 If, in fact, the plaintiff could demonstrate that
19 in the absence of the merger, the efficiencies would, in
20 fact, be achieved through some other means, then considering
21 the merger antitrust laws are forward-looking laws where you
22 basically look at price trajectories with the merger and
23 without the merger, it's legitimate in that case to say:
24 Well, if the efficiencies were achieved without the merger
25 but there was no upward pricing pressure because of the

1 reduction in rivalry among the firms, on the one hand, but
2 on the other hand if we had the merger there was a reduction
3 of rivalry, it seems to me that that's an adequate reply to
4 the defense.

5 But still the burden -- that, now, is a reply to a
6 negative defense. The burden of both going forward and the
7 burden of persuasion should remain -- should be on the
8 plaintiff.

9 As far as the passing-on aspect is concerned, at
10 least in this negative defense, basically the passing-on
11 aspect is captured in the requirement that there be a
12 downward pressure on price to begin with. Okay? It sort of
13 falls out immediately.

14 Again, in an affirmative defense version of an
15 efficiencies defense, that wouldn't be true. But in the
16 negative defense version, it falls out.

17 Now, in my case, okay, in my hypothetical, we've
18 got a shifting marginal cost curve going down which should
19 be sufficient, I argue, to discharge the burden of going
20 forward, that there is at least some gross downward pricing
21 pressure here. So the burden now of persuasion should flip
22 back to the opponent of the merger, to the plaintiff, to
23 argue that the upward pressures in price, okay? as a result
24 of the reduction in rivalry are going to outweigh those
25 downward pressures.

1 And that at least gives you a nice, coherent,
2 analytical framework, you know, to address the question of
3 how the efficiencies defense operates.

4 It doesn't -- I will be the first to admit --
5 solve any of these evidentiary problems we've been talking
6 about. But neither does the -- if you think about it,
7 neither does the 5 percent test in market definition. I
8 mean, it's very rare that you get cost elasticities of
9 econometric evidence to do the kind of cost elasticity
10 studies you need to actually get good, concrete results on
11 the 5 percent test.

12 But the 5 percent test provides you with an
13 excellent analytical paradigm in which to assess the
14 circumstantial -- the probative value of the circumstantial
15 evidence in market definition. And I think that, you know,
16 thinking about efficiencies as a negative defense, at least
17 in this case, provides you with something similar.

18 Now, you can expand this to, you know, lots of
19 other types of situations. But I would urge that, as the
20 Commission goes forward and thinks about efficiencies, they
21 could think very carefully about the doctrinal foundations
22 of the defense vis-a-vis the violation to begin with and, in
23 particular, think about the allocations of the burden of
24 proof, separating them into the allocations of going forward
25 and the burdens of persuasion.

1 Thank you.

2 COMMISSIONER STAREK: Thank you for that terrific
3 presentation. I found it fascinating. What a novel theory:
4 That we ought to look at price and make a determination as
5 to whether efficiencies are going to affect the price going
6 up or down.

7 Appreciate it.

8 Did you want to -- because I know you --

9 CHAIRMAN PITOFSKY: Well, let me apologize in
10 advance. There's a meeting out of the building that I
11 didn't know about, so I'll have to leave before you are all
12 finished. Let me leave a question lingering in the air
13 here.

14 I hope, when there's an exchange, all of you would
15 discuss the question of whether or not if you go along with
16 an efficiency defense, as Jim suggested, that it be narrowly
17 applied only in marginal cases. Your approach, it seems to
18 me, would allow an efficiency defense to trump competitive
19 considerations even when the Herfindahl's are very high if
20 the equilibrium price would be coming down.

21 So I would ask all of you to address the zone in
22 which you think efficiencies defenses -- if you're going to
23 go along with them at all -- where they ought to apply.

24 But let me not hold up Steve Salop here.

25 MR. SALOP: Thank you. I want to talk about

1 actually work that's grown out of some joint work with Gary
2 Roberts who's in the Bureau of Economics. This is a long
3 paper and long testimony, so I'll try to summarize it
4 quickly.

5 What I've done in this paper and in my testimony
6 is provide an analytic framework for analyzing efficiencies.
7 It's quite consistent with the framework that Dale set out.
8 I think all it really does is takes the analysis back one
9 step to some of the underlying economics and the tension
10 between alternative welfare standards.

11 The basic approach we take is to say that merger
12 analysis should be dynamic. It should not look at
13 efficiencies as a static concept but rather as a process
14 that takes place over time. And in analyzing the impact of
15 a merger, one needs to look at the development of prices and
16 quantities over time, not just immediately after the merger.

17 A basic framework we take is to go back to the
18 fundamental tension between different welfare standards. It
19 is my view that the reason why efficiency analysis is
20 paralyzed is not the evidentiary problem at all. I think it
21 is the tension -- it's not the lack of an analytic
22 framework. It's the fact that there are two analytic
23 frameworks, one that says that we should only look at
24 efficiency, aggregate economic welfare standard, that's
25 associated with Bork and others that says that it doesn't

1 matter if the cost saving is big enough, then that efficient
2 gain should trump a price increase, that the fact that it's
3 the stockholders that gain and the consumers that lose, that
4 doesn't matter; the monopoly overcharge is just a transfer.
5 Hey, we're all in the same society.

6 And the tension with that is the view that, no,
7 antitrust is a consumer welfare prescription; and the focus
8 should be on the impact of the merger on consumers so that
9 if it's not -- if the cost saving is not passed along to
10 consumers, it doesn't count.

11 Of course, Bork handles that. He says the
12 aggregate welfare standard is also a consumer welfare
13 prescription because, in his view, stockholders are what you
14 might call honorary consumers.

15 But the question -- that is really, I think, in
16 the political controversy, that position is lost. And the
17 mainstream is really that the consumer welfare standard is
18 the standard we should be using. And that was implicit in
19 -- explicit, rather, in what Dale Collins said. We want to
20 look at the impact on prices.

21 I also think -- and in relation to what Dale said,
22 his affirmative defense versus negative defense or Jim
23 Egan's defense versus competitive analysis is really -- the
24 defense is the aggregate welfare standard that says: Okay.
25 Price is going to go up, but we don't care. Looking at the

1 competitive effects and we're going to look at the net
2 impact, that's the consumer welfare standard.

3 So, I mean, the way I see it, I think -- the
4 question is whether efficiencies are going to be
5 dispositive. And what you do is, you first look at standard
6 competitive effects analysis on the assumption that there
7 are no efficiencies benefits. Then you look at the
8 efficiency analysis on the assumption that there's no
9 anti-competitive effects until you get one prong saying,
10 well, gee, I think price is going to go up; another prong
11 saying, well, that says price is going to go down, then what
12 you do in the balancing stage is figure out the net economic
13 impact, whether price is going to go up or down or whether
14 -- what your welfare standard is, whether that's going to go
15 up or down.

16 Okay. So within the context of pure consumer
17 welfare standard as the pricing standard, the problem with
18 that for efficiencies analysis is that you've got to have
19 huge efficiency benefits in order to get price to fall.
20 Okay? So -- you know, at least for low elasticities.

21 And so the question is: How do you get out of
22 that? How can you be true to the consumer welfare standard
23 but, at the same time, give a role for efficiencies? And I
24 think that's the analytic framework that we're all looking
25 for, not the least of which is our Chairman.

1 And I think the key to that is the recognition
2 that efficiency analysis is dynamic, that the cost savings
3 that occurs as a result of the merger diffuse to rivals over
4 time. And as they -- they'll either diffuse completely or
5 partially, rapidly or slowly; but they will diffuse. And
6 one needs to take that diffusion into account in the merger
7 analysis.

8 What are the implications of that? Well, first of
9 all, it's the diffusion of the cost savings from the merging
10 parties to the other firms that leads prices to fall. They
11 fall in the longer run. The pass-on occurs, but the pass-on
12 takes a little time, until enough firms get the cost saving
13 that the pressure to raise prices from the increase in
14 concentration are offset by the cost saving spreading around
15 the market.

16 Given that, given that the diffusion occurs and
17 the initial cost saving magnifies in the market and as a
18 result, even under the consumer welfare standard, you get a
19 big enough cost saving to benefit consumers. Hence, there
20 can be a bigger role for efficiency analysis. You don't
21 need such big cost reductions in order to offset the
22 likelihood that prices rise in concentrated markets.

23 Indeed, the analysis we've done shows that if the
24 diffusion is fast enough and complete enough, then the
25 implications for the Bork static aggregate welfare standard,

1 in fact, are equivalent to a real dynamic consumer standard.
2 That is -- if one wanted to be kind to Bork -- and I don't
3 know why one would -- but if one wanted to be kind to Bork,
4 one would say, what he had in mind was to say that if you
5 take efficiencies into the balance, in the long run,
6 consumer welfare will rise as the cost savings diffuse to
7 all the firms in the market. And so there is really a
8 complete -- sort of a fabulous confluence between the two
9 standards, if you assume diffusion is fast enough and
10 complete enough.

11 Now, of course, it isn't. Diffusion is usually
12 partial, and diffusion is somewhat delayed. And so you
13 don't get as powerful a role for efficiencies in this
14 dynamic approach as you would in the standard Bork approach,
15 but it's bigger than in the static consumer approach.

16 How big? Well, we have done some examples, some
17 simulations of a merger going from six to five, how big of a
18 cost saving do you need to have prices fall, assuming
19 partial diffusion; or if the elasticity is 1, you need 8.5
20 percent decrease in marginal cost. Pretty big.

21 If the elasticity is 2, however -- which is also,
22 you know, possible in market definition -- that required
23 cost savings falls to 3 percent.

24 Okay. So Dale said he could only do his hypo
25 qualitatively. Well, I've done it quantitatively. If the

1 elasticity is 2 in Dale's hypothetical, those parties would
2 have needed to show that the cost reduction was 5-1/2
3 percent in order for the benefits to more than offset the
4 potential harms. Okay? So it can be done.

5 So what are the implications of this as a
6 practical matter? Well, the first implication is that, in
7 doing this analysis, you should use a sliding scale
8 standard. So I disagree with Chairman Pitofsky's approach
9 of saying: We'll only allow efficiencies for moderately
10 concentrated markets; and, in moderately concentrated
11 markets, an absolute standard of say 5 percent will win.

12 In this dynamic approach, efficiencies would be
13 relevant at all levels of concentration and on other
14 barriers to entry and so on. So the more likely the
15 competitive harms are on the basis of Section 2 and 3 of the
16 guidelines the greater an efficiency benefit you need to be
17 dispositive to permit the merger.

18 And, indeed -- you know, if one takes efficiencies
19 into the balance, explicitly, you should lower the
20 Herfindahl standards because the 1,000 and 1800 are based on
21 an assumption that each merger gets the -- it's the average
22 amount of efficiencies. But if you take away that
23 presumption by putting it case-by-case, then the relevant
24 Herf's and other things ought to fall. So maybe you ought
25 to be 800 or 1600 once you take it into account.

1 The second implication is that, in this analysis
2 there's a really key role to the market demand elasticity.
3 We don't spend much time on demand elasticity in the
4 standard merger analysis. It tends to get just stuck into
5 market definition, and then there's a footnote saying it's
6 an extra factor. But, in fact, in an efficiencies analysis
7 the demand elasticity is really key.

8 If the demand elasticity is high, one can
9 tolerate, for a given assumption of efficiency benefits, a
10 much greater increase in concentration can be tolerated.

11 Third, this framework suggests new remedies short
12 of divestiture. Rather than requiring divestiture, which
13 would lead to a loss of the initial efficiencies that were
14 promised by -- that were potential by the merging parties,
15 it might be better to permit the merger but require the
16 firms to license technology in some way to speed the rate of
17 diffusion.

18 The faster the rate of diffusion, the more likely
19 it will be passed on. And so that trade off of, oh, well,
20 we'll allow you to do a merger that, in the absence of the
21 remedy, might be anti-competitive; but we'll permit it
22 because, if you do the licensing, that will speed the rate
23 of diffusion.

24 Well, the Commission has done licensing in other
25 areas; but the licensing there has been to say, well, we've

1 gone from two firms competing in this technology to one; so
2 we're going to make you divest some of the technology.
3 That's the way licensing is used.

4 I'm suggesting something quite different. They
5 get to keep the technology for their own, but they are
6 forced to license their proprietary intellectual property in
7 order to improve competition in the marketplace. But that
8 is -- in order to increase the rate of diffusion.

9 I sort of sound like -- it's within, kind of, the
10 context of what you do but with a different rationale.

11 Next implication, cognizability. Cognizability is
12 very complicated, and it's quite counter-intuitive. Ann
13 Jones said that tax savings don't count; pecuniary
14 externalities don't count. And, alas, she was doing
15 aggregate welfare analysis without being aware of it.

16 Tax savings and pecuniary economies don't count
17 because those are just transfers, as your new mentor, Robert
18 Bork, would tell you.

19 Under the pure consumer welfare standard, tax
20 savings may count because they lead to cost reductions. It
21 might be that a great way to get prices down in the industry
22 is to subsidize one firm. And with that firm subsidized, it
23 will reduce its prices; and then all the other firms will
24 have to reduce their prices in response. Consumers will get
25 the benefit. Okay? It counts in the consumer welfare

1 standard.

2 Similarly, if a firm gets a pecuniary economy, say
3 by improving its bargaining power over unionized workers,
4 that does not count in the aggregate welfare standard,
5 contrary to what Bork would probably wish, because it's just
6 a transfer from the workers to the firm or to consumers.

7 But under the consumer welfare standard, it does
8 count, because it's something that will lead to lower prices
9 to consumers.

10 So cognizability analysis of a -- cognizability is
11 somewhat different than our intuition. And the guidelines
12 -- you know, I quite agree that the guidelines put the cart
13 before the horse. They talk about all these evidentiary
14 issues without having the analytic framework. If you have
15 the analytic framework, the evidentiary issues just fall
16 out.

17 The next point, merger-specific, do the
18 efficiencies need to be merger-specific?

19 Of course, I agree with that. That's bedrock
20 antitrust analysis. If you can achieve the efficiencies
21 unilaterally, then you don't need the merger; and so the
22 merger's not reasonably necessary to achieve the
23 efficiencies.

24 With respect to conduct short of merger -- joint
25 venture, or so on -- yes, that should be in the balance if

1 you can achieve the efficiencies short of merger, then --
2 reasonably short of merger, then you don't need the merger.

3 Of course, there, the agency needs to be
4 reasonable, too. An economist -- any good economist,
5 indeed, can always write up a complicated enough contract to
6 get all the efficiencies; but they're bound to make
7 mistakes. Once the contracts get too complicated, there's
8 room for opportunism. Often you can't do, in an arm's
9 length contract -- even a complicated contract -- you can't
10 do what you can do with integration. And so that aspect of
11 less restrictive alternative has got to be treated sensibly
12 by the agencies.

13 Third issue of merger specificity is -- I know,
14 Bobby Willig used to say: Well, you needed to show that
15 this merger was necessary to get the efficiencies. Not any
16 merger. This merger. And that point I think, if I've
17 interpreted it correctly, I think is just dead wrong.

18 We don't -- when two firms merge, we don't say:
19 Well, the anti-competitive effect would like be smaller if
20 you would have bought somebody else. You know, if two buys
21 five, we don't say: Well, gee, it would have been better if
22 four bought five. We don't do that sort of industrial
23 engineering except in the failing firm defense. And I don't
24 think we should be doing it in efficiencies either. We
25 should be doing: What are the efficiency benefits relative

1 to no merger, not relative to some other merger that --
2 hypothetical merger that could be cooked up.

3 Criticisms to this approach. Well, the major
4 criticism I see is the measurement issue. It is hard to
5 measure these efficiencies, and it's hard to take things
6 into account over time.

7 I quite agree with Dale that there's no reason to
8 think that measuring efficiencies is harder than doing
9 market definition or barriers to entry. Indeed, it ought to
10 be easier since here we're just trying to analyze a single
11 firm rather than the complicated dynamics of a competitive
12 market.

13 I find it kind of funny, actually, for people to
14 say: Gee, efficiencies are harder to measure than ease of
15 entry. Because I remember back to when we were having the
16 same argument about ease of entry and everybody said: Well,
17 that's too hard to measure. And, gee, market definition --
18 we can't go beyond the Brown Shoe factors, because how the
19 heck can you try to measure the elasticity of demand? Well,
20 now we have the SSNIP test. We do that all the time.

21 In addition, I think the measurement issues will
22 get easier as the agencies get real experience. There's a
23 real chicken and egg problem now that the agencies say: we
24 can't do efficiencies based on these lousy studies that the
25 firms put in. But the firms don't put in good efficiencies

1 studies because they think the agencies won't really take
2 them seriously.

3 So I think, you know, as efficiencies analysis
4 gets acceptable, the agencies will get -- and the bar will
5 gain -- the relevant expertise and experience to make the
6 measurement easier.

7 In terms of diffusion, where I think there is a
8 real measurement issue, I don't know whether we know enough
9 about diffusion now in general. For one, I think we'll get
10 experience over time. Second, I think it would be a good
11 project for the economists to do a retrospective on the
12 amount of diffusion that occurs to try to get some sense of
13 how much diffusion occurs -- of innovation occurs in
14 markets.

15 And what we might choose to do in the guidelines,
16 it would seem to me, is rather than measure diffusion on a
17 case-by-case basis, you might put presumptive diffusion
18 rates in and use that to form, kind of, your basic
19 guidelines and then permit the parties to come in with
20 evidence that the diffusion rate in their market is
21 extraordinarily high so that the standard should be reduced.

22 Finally, remember, you don't need to have the
23 economists measure -- calculate the present discounted value
24 of dynamic consumer welfare in every case. We don't do that
25 in market definition or the ease of entry; we shouldn't do

1 it here.

2 Instead, the upshot of all of this complicated
3 analysis that I've done will be to come down with some
4 numerical standards that you would use in conjunction with
5 the numerical standards for concentration for market
6 definition and for ease of entry. This would be one more
7 set of numbers that you'll use that will go into the
8 balancing.

9 Last point. This gets -- I think there's a
10 criticism from the other side that one can be too pure about
11 consumer welfare, that this consumer welfare standard may --
12 Bork's right, consumers are real stockholders. Now it's
13 true that the distribution of stock ownership is hardly
14 coincident with income generation in our economy. Rich
15 people get a lot more capital income than middle class or
16 poor people. But it also turns out that even the middle
17 class gets a fair amount of their income from capital, from
18 dividends and capital gains. And within sort of the view of
19 a real consumer welfare standard, one can take into account
20 -- one can attribute some of that capital income to
21 consumers.

22 Gary Roberts and I did some analysis in which we
23 said: Suppose that the welfare standard involved just
24 consumers earning \$50,000 or less, the middle and lower
25 class consumer welfare standard. And we found, using a

1 consumer welfare standard based on the total welfare of that
2 group of consumers, one should take into account some of --
3 it's kind of a compromise standard between a pure consumer
4 standard and the pure aggregate welfare standard.

5 And we came up with cost reductions that were
6 somewhat lower than the pure consumer standard because those
7 consumers get a portion of the monopoly overcharge income.
8 So one could take that into account, as one should not be
9 too much of a purist in defining consumer welfare.

10 So, I think that this is a complete analytic
11 framework for analyzing efficiencies in mergers. What needs
12 to be done is, the measurement issues need to be handled;
13 one needs to kind of hammer the cognizability questions into
14 something doable; and to come up with the type of numerical
15 standards that we have in the rest of the guidelines.

16 But I think it's eminently doable if we're willing
17 to sit down and roll up our sleeves to do the hard work
18 that's necessary.

19 Thank you.

20 COMMISSIONER STAREK: Thank you very much,
21 Professor. You've, once again, educated me. Dynamic
22 testimony about dynamic analysis.

23 In fact, I can't think of when I've been more in
24 agreement with you on this matter than on others that we've
25 debated in the past.

1 The Chairman has to leave shortly.

2 So I yield to you to re-raise the question that
3 you posed earlier or, defend yourself.

4 CHAIRMAN PITOFSKY: I'm raising it and leaving.
5 Others will let me know what you have to say.

6 COMMISSIONER STAREK: All right.

7 Well, shall we begin there? Does anybody have a
8 comment on the Chairman's -- the question that the Chairman
9 posed?

10 MR. EGAN: I'll start off.

11 COMMISSIONER STAREK: All right.

12 MR. EGAN: I guess I'm in the Chairman's camp, so
13 to speak, as described at least by Steve.

14 I think it is a measurement problem. And I don't
15 know, I guess, enough about what Steve is proposing here to
16 say definitively that it sounds to me like it's a real
17 problem in translating that study into something that could
18 be incorporated into real world merger analysis. But it
19 sure sounds that way to me.

20 It's one thing to say, well, we measure entry
21 barriers; and it's another to say that we can measure
22 efficiencies with the kind of specificity that you're
23 suggesting would be required.

24 We don't measure entry barriers with that kind of
25 specificity. And, in fact, entry barriers are -- I agree

1 that, early on, there were people who were arguing -- and I
2 was probably one of them -- that entry barriers were
3 impossible to measure and, therefore, they shouldn't be
4 considered.

5 But, on the other hand, looking at it objectively,
6 entry barriers are not something that you're looking into
7 the future and trying to predict whether they will occur or
8 not. Entry barriers can be shown by historical experience,
9 by industry testimony, et cetera.

10 Again, I'm not sure exactly what you're proposing
11 and what your formula will require in terms of numbers; but
12 I have some doubt about being able to show with specificity
13 the kind of elasticity numbers and changes in marginal costs
14 which would allow us to get to any kind of conclusion on
15 balance whether the merger is going to be good for consumers
16 or bad for consumers.

17 So I guess that's my reason -- in responding to
18 Chairman Pitofsky's question, that's my reason for saying
19 that I think efficiencies are better limited to
20 consideration in the context of an otherwise marginal case,
21 traditionally measured marginal case. Because they are so
22 hard to measure, they are something that could push you in
23 one direction or the other.

24 A credibly argued efficiency could push you in the
25 direction of not bringing a case. On the other hand, lack

1 of efficiencies could push you in the direction of bringing
2 a case.

3 But to try to do it with the precision that I'm
4 hearing maybe suggested by Steve and, in some ways, by Dale,
5 it seems to me is not likely. I think back to all the times
6 that I was approached on the enforcement side with a case
7 based on a very nice economic model; and my reaction always
8 was: Well, that's very nice. Give me that model and a few
9 hot documents, and you have yourself a case.

10 And that's sort of the reaction I'm having here
11 that in the real world I'm not sure that's going to hold up.

12 MR. SALOP: Well, look, what's wrong with your
13 position is you prove too much.

14 Your argument that we can't measure any of these
15 things, you concede by that that you have no foundation for
16 the Merger Guidelines. Why 1800?

17 MR. EGAN: That's not what I said.

18 MR. SALOP: Why 1800?

19 MR. EGAN: That's not what I said. I didn't say

20 --

21 MR. SALOP: I know you didn't say it. I know you
22 didn't say it. It's an implication.

23 MR. EGAN: No, no, no. I didn't say: Don't take
24 efficiencies into account; don't attempt to measure them.

25 I'm -- all I'm suggesting -- all I'm doing is

1 reacting to your proposal, which, again, I start off by
2 saying, I don't know enough about it to say this
3 dispositively; but sounds to me like it requires too much
4 precise information to be workable. That's all.

5 MR. SALOP: Well, when I formulated the minimum
6 viable scale concepts, that's exactly what I said, too.

7 But the fact that you come down to a single --
8 that an economist can say, we care about the level of the
9 minimum viable scale or we care about the size of the cost
10 savings, well, I understand, in practice, you're never going
11 to measure these things exactly. We're going to come up
12 with ranges. Economists always do things precisely, and
13 then we give it to the lawyers and the policymakers to
14 soften it, to take our perfectly precise quantitative
15 standards and turn them into regions -- into ranges.

16 But the fact that you can't measure things
17 perfectly does not mean that you don't try to do the best
18 job that you can.

19 COMMISSIONER STAREK: I was wondering if the other
20 side of the room wants to respond, particularly Ann, if she
21 would like to respond to being called --

22 MR. EGAN: Or maybe you would like to at least sit
23 between myself and Steve.

24 COMMISSIONER STAREK: -- to be characterized as a
25 disciple of Robert Bork, which is something that would not

1 insult me whatsoever.

2 MS. JONES: My only immediate response to Steve's
3 suggestion that we'll have increased diffusion through
4 mandatory licensing of intellectual property is that it will
5 dry up your merger business pretty quickly.

6 My sense is that the Number 2 company would forego
7 acquiring the Number 5, lest it be forced to diffuse its --
8 create a level playing field, competitively, against the
9 firm with 35 percent market share, causing an interesting
10 proposition. I think it would really ease up the time
11 constraints on some of the agencies' enforcement activities.
12 I don't think that mandatory dispersion through mandatory
13 licensing is hardly viable.

14 MR. COLLINS: Just a response to Chairman
15 Pitofsky's question, I mean, it strikes me that he's raising
16 the question, as is Jim, of what amounts to the quality of
17 the evidence? Okay?

18 But it also strikes me that analytically there is
19 no reason why you should chop off the application of a
20 defense because of a quality of the evidence problem.

21 If you don't have evidence sufficient to discharge
22 the burdens, however the burdens are allocated, then the
23 defense just isn't applicable in that case.

24 On the other hand, for those cases in which the
25 quality of the evidence is sufficiently good -- and even if

1 it's a highly concentrated market but you still have good
2 evidence and nobody's questioning the quality of the
3 evidence -- it should be -- you know, you should have a
4 cognizable defense.

5 I mean, if there's a quality of the evidence
6 problem, what we need to do is address the quality of the
7 evidence problem, not cut off the domain of the defense.

8 The other thing on -- just on Steve's paper,
9 generally, I think that, you know, the approach that he's
10 taking is very similar to the approach that I articulated.

11 And I think that the measurement problems are not
12 as severe as a lot of people would initially think. I mean,
13 if you think about it for a second, the 5 percent test is a
14 test that goes to elasticity of demand. It doesn't have a
15 whole lot -- it, analytically, is not a whole lot different
16 than some of the things you'd have to measure in order to do
17 Steve's analysis on the demand side; and, as far as the cost
18 side, it's already -- I think Steve's already pointed out,
19 you really only have to look at a couple of firms as opposed
20 to the whole industry. That should be an easier exercise.

21 So if you buy into the analytical framework -- I
22 think there are some questions about parts of the
23 analytical, but they're more in terms of refinements than
24 fundamental challenges. I don't think the evidentiary
25 problem is that great.

1 COMMISSIONER STAREK: It's time to hear from the
2 Director of the Bureau of Economics. I'm anxious to know
3 whether he will adopt his deputy's analysis here and we will
4 be seeing new analysis -- dynamic analysis of efficiencies.

5 MR. BAKER: I think I need to as -- as you can --
6 this is a surprising Commission here that we're sort of
7 doing these sort of hearings; and in that spirit, I'm going
8 to ask a legal question and leave your economic question to
9 my colleague here, Bill Baer.

10 COMMISSIONER STAREK: Oh, all right.

11 MR. BAKER: Who will also explain why the Cournot
12 model is or isn't a good assumption for doing an academic
13 analysis of Steve's paper.

14 We asked all of our speakers, including you folks,
15 to think broadly and received a whole lot of interesting and
16 far-reaching proposals, including today. And, in that
17 spirit, one of our earlier speakers at an earlier session,
18 Tom Jorde, submitted some testimony which proposes -- and
19 this is my characterization, not Tom's -- that antitrust law
20 should take dynamic efficiencies into account in high
21 technology and innovation industries by essentially
22 restructuring the rule of reason analysis to take away some
23 of the pro-plaintiff features, but outside of the
24 efficiencies defense narrowly understood.

25 So some of -- in Tom's testimony he says, for

1 example, we should, in the rule of reason analysis, in order
2 to take -- in order to properly address efficiencies, we
3 should create a market power safe harbor; we should allow
4 market power in future markets to play a role towards -- to
5 count towards proving efficiencies in rapid -- industries in
6 rapid technological change where innovation will -- the
7 innovation will compete with other technologies.

8 And he suggested we remove the less restrictive
9 alternative analysis of the rule of reason from being a
10 trump and, instead, consider large -- big and obvious less
11 restrictive alternatives within the efficiencies analysis
12 rather than elevating them to a separate stage of the rule
13 of reason analysis.

14 Regardless of what Tom's specific proposals are --
15 and I don't mean to ask you about that -- I'm using that as
16 a vehicle to ask the following question, which is: Should
17 we be thinking -- in addressing the important role of
18 efficiencies in joint ventures as well as mergers, should we
19 be thinking about going beyond working out the details of
20 the efficiency defense? Or is everything that we need to do
21 here something that we can do within the efficiencies
22 defense without need for restructure the rule of reason and
23 joint venture analysis or the Merger Guidelines -- other
24 aspects of the Merger Guidelines?

25 Now, Dale's proposal sort of seems to go to

1 competitive effects, in part. Steve has a view that we
2 should be thinking about, you know, dynamic consumer welfare
3 standard.

4 Does that call for, Steve -- maybe I should ask
5 you first -- does that call for a change in how we think of
6 the whole analysis generally? Or is it going to be done
7 within the efficiencies?

8 MR. SALOP: No, I think it could be done within
9 efficiencies. I mean, I think I'm within the competitive
10 effects regime. I mean, there's just one more element to
11 competitive effects. I mean, there's some stuff that tends
12 to lead to welfare going down, some stuff that tends to lead
13 to welfare going up; and you need to balance them.

14 When I talk about balance and balancing
15 competitive effects, I'm balancing forces in one direction
16 against forces in another direction. I'm not saying that
17 one trumps -- the one thing -- if the price -- if you could
18 show that prices are going to go up, then no matter what the
19 efficiencies -- net of taking the efficiencies into account,
20 then the defendant loses.

21 The question is: Once you take the efficiencies
22 into account, are you going to be comfortable in saying that
23 prices are going to go up? Okay. So I'm within the
24 competitive effects.

25 On Jorde, I think, you know, Jorde was thinking

1 about innovation, dynamic competition, long before a lot of
2 us were. And so I think his work is valuable in that
3 regard. But I think, in general, he goes much too far. I
4 mean, eliminating less restrictive alternative, I think, is
5 a mistake. I think putting all of the burdens on the
6 plaintiff is wrong, in fact, and inconsistent with Jorde's
7 work on presumptions and market definition, I suppose.

8 You know, the burden of proof should be who's got
9 better access to the information? That should be an
10 important element.

11 He also, in his market -- in his various safe
12 harbors, he commits the Cellophane fallacy. I mean, he
13 builds analysis as if we have in mind collusion, but he then
14 wants to apply the analysis to situations of exclusionary
15 conduct. And for that, you cannot do market definition in a
16 vacuum in the way he does.

17 So, you know, I think the idea that we should take
18 dynamics and take innovation into account is good; but we
19 don't need a wholesale rewrite of the rule of reason or the
20 antitrust law.

21 MR. COLLINS: Let me take a shot at this, too.

22 I think that's exactly right. But I think -- in
23 other words, I think that you can do everything that you
24 need to do within the basic framework of the guidelines.
25 But I do think the guidelines need to be -- or at least some

1 thought needs to be given to two specific aspects of the
2 guidelines, which are -- both of which were raised by Steve.
3 Okay? And both of which the guidelines are silent on today.

4 One is, if you will, the welfare standard. I
5 think one of the biggest problems in the antitrust debate
6 today and has been for years is that people use words such
7 as "consumer welfare" when they're talking to one another;
8 but the people in the conversation each have a different
9 standard of what consumer welfare is. And they don't know
10 it. They don't know that they're using different standards.
11 They don't know that consumer welfare is different than
12 total surplus and that you might get differences on things
13 like the use of a compensation principle or Pareto
14 optimality. Those things can give you different results in
15 the same case. Okay? And there needs to be some
16 convergence in the debate of what the standard is. That's
17 number one.

18 The other thing is that, to the extent that we
19 introduce -- and I think we should -- more dynamic analysis
20 into the merger calculus, there -- what will happen is that
21 there will be different effects at different points in time.

22 I mean, you can conceive of situations where the
23 prices drop as a result of an acquisition fairly quickly;
24 but, in the long run, they settle down at a level that would
25 be higher than they would be in the absence of the

1 acquisition. So, in other words, the price trajectories
2 cross one another.

3 Then we have to figure out how one takes that into
4 account, which could be incorporated back into the question
5 of what the welfare standard is. But we do need to think
6 about how you balance different effects at different points
7 in time. And the guidelines are silent on that.

8 MS. VALENTINE: Jon, this is -- is a related part
9 of your question -- and this, I would actually like answered
10 by the panelists more than Jon.

11 If we are looking at --

12 MR. BAKER: I'll get my chance later.

13 MS. VALENTINE: You can answer, too.

14 -- at thinking about how to do efficiencies and
15 we've got some domain limitation, either stopping at
16 moderate concentration the way Ann proposed or limited to
17 cases on the margin, then how are we going to think about
18 industry-wide joint ventures?

19 What would you two do with efficiency claims in an
20 industry-wide research joint venture or BMI situation? And
21 why should we not be thinking about efficiencies similarly
22 in both cases?

23 MR. EGAN: Well, if I understand the question, the
24 ultimate question -- I subscribe to what Steve and Dale, I
25 think, both also subscribe to -- and that is that ultimately

1 the question is impact on competition. And in joint venture
2 analysis -- I think there's more clarity in joint venture
3 analysis about the -- there's not the specificity that some
4 would like in terms of integrating efficiencies analysis.

5 But the basic analytical framework is, it seems to
6 me, better understood in the context of joint ventures. I
7 don't understand why it isn't easily adopted for the -- in
8 case of mergers.

9 And the essential question asked in BMI is: Given
10 the context of this joint venture, is the consumer going to
11 be offered more choices, better choices, or less choices,
12 and fewer choices? And, ultimately, is competition going to
13 be lessened or increased?

14 And because of the factual circumstances there,
15 the answer was competition is actually going to be
16 increased. Consumers are going to have more choices.

17 And that's the way that efficiencies can be
18 integrated -- are integrated into joint venture analysis.
19 It seems to me, when physicians join together -- local
20 physicians join together in a network in order to offer
21 their services, the antitrust agencies allow those
22 physicians to do so as long as there's something more that's
23 being offered to the consumer, as long as there's some
24 integration which offers a consumer more choices or better
25 choices than were being offered before.

1 Once you get past that point, then there is a
2 balancing. If all the doctors -- if 100 percent of the
3 doctors in a city got together and integrated their
4 services, there may be something different or more; but then
5 the balancing comes in. And is it enough to offset the fact
6 that all of the doctors are now pricing from the same point?
7 And also then you get into the question of whether that's
8 necessary in order to accomplish the integration. Is it
9 necessary for all the doctors to do it?

10 I don't know whether I answered your question.

11 MS. VALENTINE: Well, that sort of -- Ann, would
12 you ever let us look at efficiencies in a highly
13 concentrated situation?

14 MS. JONES: I must confess, I'm -- as a worker
15 bee, I'm boggled by Steve's proposition in terms of
16 quantifying things. From the types of materials that are
17 currently presented in a kind of working merger context, I'm
18 just a working lawyer; and so, perhaps, you have to take
19 them with a huge grain of salt. I crept through calculus by
20 the skin of my teeth.

21 And while I find your ideas fascinating, its
22 working models, paper-driven inquiry, I just find it very
23 difficult to believe.

24 I think the rule of reason, as articulated by a
25 series of Supreme Court cases, said maybe the reasoning and

1 the analysis is so much better because the Supreme Court has
2 given a fair amount of guidance in the area of joint
3 ventures, in the area of ancillary restraints. They have
4 not done that in the area of efficiencies. They have sort
5 of -- when they talk at all, they repudiate them.

6 Maybe that's one of the problems, is that we don't
7 have that kind of guidance coming from courts.

8 But I think they're adequately taken into account
9 currently. And unlike Tom's characterization of the rule of
10 reason, I find that the plaintiff -- the prospect of a
11 full-blown rule of reason inquiry quite daunting.

12 MR. EGAN: Can I just throw in, it seems to me
13 that the next logical step -- it may be -- I certainly
14 didn't mean to suggest that a more specific inquiry is --
15 that there can't be -- if a 5 percent test could be -- if
16 Steve could come up with the equivalent of a 5 percent test,
17 which would respond to these kind of questions, that would
18 be great and something that certainly should be considered
19 to be used.

20 I'm not aware of such a test right now.

21 It seems to me the next logical step in this
22 process is to -- and I think there is some agreement here
23 about this -- the next logical step is to at least have the
24 basic framework, the basic analytical framework put in place
25 for consideration of efficiencies.

1 And that would do two things. It would exclude --
2 the implication would be to exclude certain types of
3 efficiencies. And, on the other hand, by implication, it
4 would place increased importance on other types of
5 efficiencies and allow both sides -- both the enforcement
6 agencies and the firms -- to focus their intention on what
7 is truly relevant.

8 Now, that's the next step, it seems to me. Beyond
9 that, there may be a model which can be developed which --
10 and maybe Steve has taken some steps in that direction.
11 There may be a model to be developed. But it seems to me
12 that's down the road. It seems to me the next step is just
13 to take the guidelines and insert into the guidelines some
14 clarity as to how efficiencies are going to be integrated,
15 just in general terms, into the analysis and that it's not a
16 defense.

17 MR. BAER: I was simply going to following on Jim
18 and Ann's point by asking these experienced practitioners
19 and economists who have been involved in cases to what
20 extent do you all think, today, that -- in what percentage
21 of cases that you have been involved are we developing the
22 kind of evidence that would fit into the model that Steve
23 and Gary are developing?

24 And a second part to my question is: On the
25 assumption that there are lots of cases where the evidence

1 is going to be mixed, what do people think about Dale's
2 suggestion that, effectively, uncertainty is going to be
3 resolved in favor of letting the merger go through under his
4 negative defense option?

5 I mean, it seems to me, as a practical enforcement
6 perspective -- which every once in a while I wander back to
7 -- it's helpful to know.

8 I have to tell you, in six months the quality of
9 the efficiencies work I've seen hasn't been terrific. Now,
10 we have lacked, I think -- and these hearings are going to
11 be helpful -- in developing --

12 MR. BAKER: You're speaking just about the --

13 MR. BAER: No. But Jim's point is right. I think
14 with a better framework, we're going to be better able to
15 ask questions and to evaluate the worth of what we're
16 getting.

17 And I think you made that point earlier on, Dale,
18 as well. But it would be helpful to know what people think
19 about the quality of evidence we can generate now that
20 you're seeing, as you put cases together.

21 MR. SALOP: I am really sort of -- I would be wary
22 of the former government lawyer who says: I'm just a poor
23 government bureaucrat; and the former assistant to the
24 Assistant Attorney General saying: I'm just a worker bee.

25 It's sort of time for us to hold onto our wallets.

1 I want to sort of respond to what Jim said and
2 then kind of answer it.

3 I think Jim and I are in complete agreement. I
4 mean, I think that the next step is to write a good four
5 paragraphs on the efficient -- you know, get rid of the four
6 -- get rid of the two paragraphs that are in the
7 efficiencies section, write four good paragraphs which says:
8 We care about consumer welfare; we're going to look at it
9 dynamically; we care about diffusion; relevant factors are
10 the level of concentration; barriers to entry; and the
11 elasticity of demand.

12 And, you know, I do not want to put tables 2, 3,
13 and 4 in my paper into the Merger Guidelines. We are
14 clearly not ready to do that. You just qualitatively say:
15 Okay. We figured out what the framework is. Write that
16 down. And then, you know, when you do guidelines version
17 4.1, in a couple of years, then you'll be -- you'll be ready
18 to do numerical standards.

19 COMMISSIONER STAREK: We could talk on this all
20 afternoon; and if anybody else has a final comment on this
21 matter, please, I don't want to cut you off. But we do have
22 to, unfortunately, conclude.

23 However, I would certainly invite all of the
24 participants to follow up and send us additional submissions
25 if other thoughts or there are other comments that you'd

1 like to put on the record regarding the discussion that we
2 had today.

3 Is there anybody who has a final comment on Bill's
4 question?

5 MR. EGAN: Do I get the last word?

6 MR. SALOP: That's typical, Jim.

7 COMMISSIONER STAREK: Well, I sat across from him
8 at the table for many years; and he always got the last word
9 in.

10 MR. EGAN: I was never accused of being efficient.

11 I mean, let me just confirm that your six months
12 simply confirms a number of years that I saw that the -- I
13 don't think that the -- I'm not sure that the problem is one
14 of measurement. I mean, there is that -- that's a very
15 important problem.

16 But I think the reason why so many efficiency
17 defenses are so poorly presented is because there is not a
18 true efficiency defense or efficiency aspect to the merger.
19 And that is why I think it's important to have more
20 direction on this, because I think you want to send a signal
21 that, yes, we will look at it in these circumstances; no, we
22 won't look at it in these circumstances. And you won't be
23 overwhelmed by saying this time and time again, when it's
24 not really relevant to the inquiry.

25 COMMISSIONER STAREK: Well, thank you, all. I

1 really appreciate it. And, as I said, please take me up on
2 the offer to send in additional thoughts or comments.

3 (Recess.)

4 COMMISSIONER AZCUENAGA: Good afternoon. It's a
5 real pleasure to welcome, for this second session this
6 afternoon, three high officials who are friends and from our
7 sister competition agencies, both in Mexico and Canada.

8 So it's a pleasure to see all of you.

9 And we're going to begin with our first speaker
10 this afternoon who is Dr. Pascual Garcia Alba who is
11 Commissioner of the Federal Competition Commission in
12 Mexico.

13 He has previously served as Under Secretary of
14 Educational Coordination in the Ministry of Education and as
15 Under Secretary of Planning for Development and Budgetary
16 Controls in the Ministry of Planning and Budget.

17 From 1988 to 1992, Dr. Alba was the Director
18 General of Social and Economic Policy in the Ministry of
19 Planning and Budget.

20 Since 1992, Dr. Alba has served on the Board of
21 Directors for Colegio de Mexico. He is also a professor at
22 Colegio de Mexico where he teaches courses in economic
23 theory, statistics, and econometrics.

24 And welcome, Mr. Alba.

25 MR. GARCIA ALBA: Thank you.

1 Well, first of all, I would like to apologize
2 because of my lousy English. So I'm going to make you a big
3 favor: I'm going to be very brief.

4 Well, the idea of my paper is that in a country
5 like Mexico, you are bound to have to choose concentrations
6 in industry macro structure because of the size of the
7 market.

8 Of course, you can say that the national market
9 probably is not the relevant market. But, anyhow, in the
10 United States, you almost always end up by analyzing the
11 domestic market.

12 Well, this poses several problems because, while
13 in the Mexican Commission, we have been following, more or
14 less, the American guidelines for mergers, which we use the
15 Herfindahl Concentration Index, which always increases with
16 any merger, with any concentration allowed.

17 Given the size of the Mexican market, almost all
18 mergers in Mexico would be an object of disagreement by the
19 Commission because they imply -- usually they imply large
20 increases of the Herfindahl index.

21 In that sense, I think that all the biases of the
22 Herfindahl analysis are especially dangerous in a country
23 like Mexico. So the idea was to construct an index which
24 would not always increase with mergers.

25 Well, beginning from the fact that the theory has

1 established that when you have a market structure in which
2 there are no big difference of size among the different
3 industries or firms within that relevant market, then the
4 Herfindahl index is very correlated with the prices and
5 profits, et cetera, which means that probably the Herfindahl
6 index is a good index in that kind of setting.

7 Well, but when you have a market structure in
8 which you have, let's say a firm which takes account of more
9 than 50 percent of the supply, let's say, and then you have
10 a lot of very small firms, then you can have a very large
11 Herfindahl, let's say in the range of a very concentrated
12 market. And then any concentration in any merger among the
13 small firms will increase the Herfindahl more than 50
14 points. And then you will, in principle, challenge any
15 merger in that market.

16 However, there are some results in theory which
17 say that when you have a dominant player with more than 50
18 percent of the market, in principle there are -- in
19 principle, all profitable mergers among non-dominant firms
20 will increase welfare, which I think is a very strong result
21 if taken literally; to approve any merger in those cases
22 would bias the analysis. But still the idea is that in that
23 situation there can be mergers that increase welfare.

24 Then there is another suggestion that was made
25 many years ago by Bork that he suggested that if a merger

1 was taken among several firms which together accounted for
2 such a big share of the market that no other merger among
3 other firms could be made in that market so that in that
4 situation you will expect that the -- the probability that
5 the goal of the merger wasn't competitive --
6 anti-competitive or against competition, that the different
7 participants in that merger will have the goal of displacing
8 other firms or have uncompetitive goals.

9 Then, with those ideas and the fact that the index
10 H in the Mexican context was very biased against almost any
11 merger, the idea came up to produce another index which gave
12 the same results as the Herfindahl index for cases in which
13 all the firms are of the same size, but that under some
14 circumstances some mergers could actually decrease the value
15 of the index.

16 So the idea was not as much to change completely
17 the idea of the Herfindahl index but to compute it from a
18 different set of numbers. Instead of computing the
19 Herfindahl index over the market shares of any industry, the
20 idea was to compute the Herfindahl over the contribution of
21 every firm to concentration to make sure that's with the
22 index H. It means that the index of concentration or
23 concentration is kind of another Herfindahl index.

24 If you define that instead of where you have these
25 squared shares in the Herfindahl, with the squared market

1 shares, therefore, the Herfindahl index is an index of the
2 average size of every firm in the industry.

3 But if you have the squared share divided by the
4 -- of every firm divided by the Herfindahl and then over
5 that you compute the Herfindahl, you are taking into account
6 the position of every firm as against the sizes of the other
7 firms in the market. That's why it's a relative -- relative
8 -- I call it a size dominance index of market structure
9 analysis, because it takes into account not only the size
10 for the computation of that index, not only the size -- or
11 the share of every firm, but it's contribution to
12 concentration. And then after all it is a Herfindahl but a
13 second-order Herfindahl.

14 The properties of this index are -- well, more or
15 less, the following nine of them go into that detail.

16 First of all, the minimum size of the index is the
17 reciprocal of the number of firms, which is the same as the
18 Herfindahl. It's 1 over N, the number -- where N is the
19 number of firms. And that is the only distribution when
20 both indexes coincide.

21 In other cases, the index -- the size dominance
22 index is always larger than the Herfindahl.

23 Other properties are, for example, that if you --
24 maybe I should -- excuse me. I have to use my glasses.

25 Another property is that any transfer from

1 production to any firms to the largest firm on the market
2 always increases the index, which is a rather obvious
3 criterion to use.

4 And, therefore, any measure in which the dominant
5 firm, the largest firm in the market participates, that
6 merger always increases the index.

7 Another property is that a merger of two firms is
8 such that the resulting share of the merging firms is larger
9 than the one resulting from the merger of any other two
10 firms always increases the index. That's the Bork
11 criterion, which I was mentioning a moment ago.

12 Now, if the merger of two firms, or more than two
13 firms, results in a merged firm that accounts for more than
14 50 percent of the market, then that merger always increases
15 the index, which is more or less related to the 50 percent
16 of the benchmark criterion that has been mentioned in the
17 literature about mergers.

18 If, on the other hand, a firm has a share which is
19 more than half the market and any other firms other than the
20 largest one merge in that condition in which there is a
21 dominant margin -- a firm with more than half the market, in
22 that case, the index always increases, which is consistent
23 also with the 50 percent benchmark idea.

24 Well, I think those are the main dominant
25 properties which I believe are more or less related to what

1 some theorists and antitrust practitioners have suggested
2 for merger analysis.

3 And, of course, any -- as I got from the last
4 session, everybody's trying to, in some way or another,
5 modify the guideline criterion. I'm proposing that for the
6 Mexican Commission.

7 And in Mexico, we have been using this dominant
8 index, not in substitution of the Herfindahl index; but we
9 have been doing some experimenting. And of most of the
10 final decisions of the Commission about mergers and other
11 cases of structure analysis, I think that the final result
12 of the Commission has been most related to the behavior of
13 the dominance index rather than with the Herfindahl index.

14 I think that it's more related to what theory
15 says. Of course any concentration index should increase
16 always with any concentration with any merger; therefore,
17 the dominance index is not a concentration index.

18 Also, I think that experience of hiring the
19 Commission, I think that points in the sense that the
20 dominance in the -- size dominance index is useful and
21 probably more useful in the case of Mexico than the
22 Herfindahl index.

23 We also carried out an econometric analysis, which
24 I don't include in the paper because antitrust authorities
25 always use confidential information, and you cannot put it

1 in paper. But we analyzed a market related to some kind of
2 transportation in which it has been proposed that every
3 route is a relevant market. So that way we could look at a
4 configuration of 97 relevant markets.

5 And then we introduced several variables. In one
6 version of the regression, we used the Herfindahl. In
7 another version, we used size dominance index. And in
8 another version, we used both.

9 And, well, it happens that when Herfindahl is
10 used, it is significant, statistically significant. But
11 also the size dominance index is significant. And when both
12 are used, Herfindahl loses the significance; and the size
13 dominance index is very significant.

14 So I will leave it there.

15 COMMISSIONER AZCUENAGA: Thank you very much,
16 Commissioner Alba.

17 I didn't mention that Commissioner Alba also has a
18 PhD in economics from Yale. I just saw his paper just
19 moments before sitting down this afternoon and managed to
20 flip through it, and I have to say I'm going to have to have
21 the economists help me interpret it, I believe.

22 But I did get some sense of your theory from
23 listening to you just now. And it sounds like a very
24 interesting and useful theory. I have a couple of
25 questions, and others may have more.

1 You say this would be useful in Mexico, and I
2 didn't quite understand the reason. Is that because of size
3 of the country or the nature of the economy?

4 I wonder if you might explain again why this new
5 index is appropriate for Mexico.

6 MR. GARCIA ALBA: Well, I don't want to sound very
7 preposterous -- or do you say that? So I propose it for
8 Mexico; but actually it could be useful also for the U.S.

9 COMMISSIONER AZCUENAGA: Ah, that was going to be
10 my next question.

11 MR. GARCIA ALBA: Then the other part of the
12 question is I think that the Herfindahl analysis is somehow
13 biased against mergers. That's why you use several ranges
14 in which a proposed merger to be or not to be -- how do you
15 say -- opposed by the Commission to a deeper analysis.

16 I think that that bias is especially troublesome
17 in a small economy because, for example, let's say you have
18 -- let me talk about a specific case in Mexico. We have the
19 cellular phone companies. And we had the main player, which
20 had about 50 percent of the market, which was also the
21 operator of basic telephone in the whole of the country.
22 And he was given a concession to open also cellular
23 telephones.

24 And together with that company, there were another
25 nine companies which were comparatively small with the

1 dominant one, which was also the basic telephone operator.

2 Well, we have had several other mergers among the
3 smaller companies. But if you analyze that through the
4 Herfindahl index, the market is very concentrated. And all
5 mergers in that market increased the Herfindahl a lot.

6 However, the Commission thought that, given the
7 structure of the market in which there was a dominant player
8 which had more than 50 percent of the market, to allow
9 mergers among the smaller industries would increase
10 contestability in the market because by merging, the small
11 firms would be in a stronger capacity to oppose any
12 displacement policies carried out by the dominant player.

13 So let's say that we had -- we were happy with the
14 results of the Herfindahl analysis, we wouldn't have ever
15 approved those kinds of mergers, which we did approve.

16 Of course, all this index analysis is only some
17 part of the whole picture. You have to go into the study of
18 the other limits. But from the start, it biased the
19 emphasis in one way or another.

20 For example, in that market structure of the
21 cellular phone companies, when you use the size dominance
22 index, which I proposed, the index always decreases with
23 those kinds of mergers. Because, as I said, when there is a
24 lot -- the index has a property that when there is a
25 dominant player which accounts for more than half of the

1 market, then all other mergers will always -- the largest
2 one will always decrease the index, which is, as I said, in
3 accordance with some results of theory, that 50 percent
4 benchmark.

5 Of course, having a small country, those kind of
6 situations are more frequent because in every market
7 increase, the relevant market is the domestic economy, you
8 are bound to have only two or three significant players and
9 a lot of small ones.

10 In the case in which the market is clearly the
11 international market because we are talking about tradeable
12 goods, in those cases, the Mexican Commission usually
13 approves any merger without concentration analysis -- well,
14 we have to -- we have to compute the concentration, et
15 cetera; but in the end, it doesn't have any role in the
16 final decision, because if we have -- we are a small economy
17 and there are tradeable goods and there are no tariffs, et
18 cetera, and transportation costs are pretty small. If we
19 only have one firm, it's okay. That firm doesn't have any
20 power to exercise monopolistic practices.

21 But what is really relevant in the case of Mexico,
22 which has become a very open economy, is to fight
23 concentration and monopolies in the non-tradeable sector of
24 the economy.

25 And by becoming a more open economy, it is even

1 more relevant to have an antitrust policy designed to
2 prevent monopolies in the non-traded sector of the economy,
3 because if we have monopolies in the non-traded goods sector
4 and we have perfect competition only in the traded sector,
5 well, that's the worst situation because if you have
6 distortion on one side, the best market structure is not to
7 have distortions -- not to have distortions in the other
8 side is the second best. That's a result.

9 If we allowed monopolies in the non-traded sector
10 of the industry, we would lose a lot of competition because
11 the non-traded goods are always the traded ones.

12 So having an open economy is a stronger reason to
13 have a strong antitrust policy in a non-tradeable sector.

14 COMMISSIONER AZCUENAGA: A very practical
15 question: You've indicated that you have used the size
16 dominance index in some cases already, along with the
17 Herfindahl, or on its own.

18 Is this something that your agency has written
19 down? Or is it still in terms of your own policies or
20 rules? Or is it still something that you just consider in
21 your discretion when you're talking about a case?

22 MR. GARCIA ALBA: Okay. In the -- well, as you
23 know, the Mexican Commission was created only two years ago.
24 And in the first annual report, this index is mentioned in
25 the whole of the -- the main idea is more or less explained,

1 not in detail. But it is in the annual report of the first
2 year.

3 Other than that mention in that report, not
4 another official use of the index has been made.

5 But in Mexico, still almost nothing is official
6 because our Commission is so young that not even the
7 Herfindahl index is an official practice. You cannot find a
8 statement which says that the Commission will use the
9 Herfindahl index to analyze a situation. We do it in
10 practice, but there is not an official handbook or manual
11 like the guidelines. The people expect us to use something
12 like the American guidelines.

13 COMMISSIONER AZCUENAGA: Do you use this index to
14 establish a safe harbor? Or is it more of a presumption
15 when a particular transaction reaches a certain level?

16 MR. GARCIA ALBA: More like a presumption in this
17 stage.

18 COMMISSIONER AZCUENAGA: Thank you. That's a very
19 interesting concept that I think we'll have to study.

20 But let me ask if there are others with questions,
21 including our Canadian guests.

22 MS. VALENTINE: Do they want to use it?

23 COMMISSIONER AZCUENAGA: That's right.

24 MS. VALENTINE: Are you interested.

25 MS. SANDERSON: I think we'll take it back.

1 COMMISSIONER AZCUENAGA: Very good.

2 MS. DeSANTI: I was very interested, especially
3 since one of the things that we're hearing during these
4 hearings is that there are certain industries in the United
5 States where the number of competitors is going down; and
6 one of the arguments that's being made is that that's not
7 necessarily anti-competitive. In some circumstances, it may
8 be pro-competitive. All right.

9 I'm quite sure that my level of economic expertise
10 is less than Commissioner Azcuenagas, and I definitely need
11 at least one economist to go through all of this so I can
12 understand it.

13 But let me ask you: How did you arrive at the
14 decision to use the 50 percent threshold?

15 One of the thresholds that's been suggested in the
16 United States for a similar way of thinking about things
17 would be more like 35 percent.

18 What was your reasoning in choosing 50 percent?

19 MR. GARCIA ALBA: Well, I only know of theoretical
20 papers that come up with that figure. I think other kinds
21 of thresholds like 35 percent, et cetera, are more
22 conventional. The 50 percent mark comes from theoretical
23 models. And I haven't seen another threshold like that.

24 MS. DeSANTI: I'm not sure I understood correctly,
25 but I had the impression from what you said that the index

1 -- your size dominance index would always increase if there
2 were one firm in the market that had 50 percent or more.

3 Does that mean if that firm were one of the
4 parties involved in the acquisition or --

5 MR. GARCIA ALBA: Yes. Only in that case.

6 MS. DeSANTI: Only in that case.

7 MR. GARCIA ALBA: Otherwise, the index will always
8 decrease.

9 MS. DeSANTI: So even if there were, say, three
10 firms --

11 MR. GARCIA ALBA: Yeah.

12 MS. DeSANTI: -- okay, you could have a merger of
13 Number 2 and Number 3, and your size dominance index would
14 not increase?

15 MR. GARCIA ALBA: That would mean that -- if I
16 have a 50 percent firm and two 25 percent firms, in that
17 case, if the two 25 percent firms merge, the index remains
18 at 50 percent, or 5,000 equivalent of the Herfindahl index.

19 MS. DeSANTI: Thank you.

20 MS. VALENTINE: Well, actually just to make sure I
21 understand this so that this is not just a numbers game, I
22 assume.

23 Then you also do go on and look at an
24 anti-competitive or competitive effects analysis as well,
25 when you said, in fact, you found that the dominance index

1 was significant when the HHI index often was not
2 significant. Were you, then, looking at what you thought
3 competitive effects were in the markets as well?

4 MR. GARCIA ALBA: Well, this analysis was not
5 carried out for a specific case. It was more for
6 theoretical and experimental reasons.

7 What we did was kind of a configuration that had
8 been used in the airline industry. I'm not saying that I
9 used that index for the airline industry in Mexico.

10 There are several studies, papers, for the airline
11 market in the U.S. in which to explain prices. You have the
12 distance. You have the kind of travel or trip. You have
13 frequency. And then you have concentration.

14 And most of those studies conclude that the most
15 important variable to explain variations in price with
16 travels of the same distance is concentration.

17 If you don't use concentration, then you come up
18 with nothing, because you have travels of the same distance
19 with very different prices. And if you don't throw in the
20 relative concentration, then you cannot explain anything.

21 Well, the idea was to compute that kind of
22 configuration, but instead of using Herfindahl using this
23 index. But, of course, when the Mexican Commission analyzes
24 a proposed merger or some antitrust case, we have to
25 consider all other elements, competitive, anti-competitive,

1 and we use -- well the rules of the Mexican Commission are
2 inspired by the rules of the Federal Trade Commission and
3 the Department of Justice.

4 The Commission helped a lot in the setting up of
5 the Mexican Commission, so no wonder that we adopted almost
6 every aspect of the way that you do things in the U.S.,
7 except that we mix the functions of the Department of
8 Justice and of the FTC. We have it in the same Commission.

9 But when -- as well as with the guidelines, when
10 we analyze a case, we don't look only at the concentration.
11 We look at pro-competitive elements and anti-competitive
12 elements. We have a rule of reason, et cetera.

13 COMMISSIONER AZCUENAGA: Thank you. This is
14 fascinating. And I just think we need to move on, but I
15 will say that, to the extent that you took anything from us,
16 we will look forward to reading your paper to see -- that's
17 one of the nice things about having a new competition agency
18 in one of our neighboring countries, that we have yet
19 another place where we can turn for new learning.

20 So thank you very much.

21 MR. GARCIA ALBA: Thank you.

22 COMMISSIONER AZCUENAGA: Our next speaker is
23 Francine Matte.

24 She is the Senior Deputy for mergers in Canada's
25 Bureau of Competition Policy.

1 Prior to her appointment in August 1994, Francine
2 was Director of Legal Services in the market framework unit.
3 In that capacity, she advised the Bureau of Competition
4 Policy.

5 From 1987 to 1990, Ms. Matte was Corporate
6 Secretary to Investment Canada; and from 1983 to 1985, she
7 was Special Advisor to the Deputy Minister of Justice. In
8 addition, she was appointed Queen Counsel in 1986.

9 Throughout her 23 years of service in the
10 government, Ms. Matte has occupied several managerial
11 positions and has acted as legal counsel for many
12 departments and organizations, including, among other
13 things, the Department of Regional Economic Expansion, the
14 Department of Consumer Affairs, and the Treasury Board.

15 And it's been our pleasure to work with her over
16 the years. And welcome.

17 MS. MATTE: I, too, will use my glasses.

18 Just a word of introduction. I think what
19 Margaret and I are going to do today, on October 25th, I
20 sent to the Commission a copy of Margaret Sanderson's paper
21 on efficiency in Canadian merger law.

22 What we have done today is reformat the paper.
23 And so Margaret will be addressing some of the slides, and I
24 will be addressing some of the slides.

25 COMMISSIONER AZCUENAGA: All right. Well, maybe I

1 should introduce Margaret as well.

2 MS. MATTE: Maybe as well.

3 COMMISSIONER AZCUENAGA: I have something to say
4 about Margaret as well.

5 Margaret Sanderson is Chief of the Enforcement
6 Economics Division in the Economics and International
7 Affairs Branch of the Canadian Bureau of Competition Policy.
8 In addition, she has assumed the duties of Acting Director
9 of the Branch for six months. The Enforcement Economics
10 Division provides economic analysis to the Bureau of
11 Competition Policy's enforcement branches.

12 Prior to joining the Enforcement Economics
13 Division in September 1992, Ms. Sanderson held various
14 positions within the Bureau of Competition Policy's Mergers
15 Branch.

16 In 1988, she joined the Bureau of Competition
17 Policy as an economist within the Economic and Regulatory
18 Affairs Branch.

19 She has also worked at the Corporate Tax Analysis
20 Division of the Canadian Department of Finance.

21 So you see, with these two here, we really have
22 the brain trust of Canada's Bureau of Competition Policy.

23 COMMISSIONER VARNEY: George would agree with
24 that.

25 MS. MATTE: Yeah, George would agree that Margaret

1 has all of the knowledge and expertise in this area.

2 Let me begin by thanking the Commission for your
3 kind invitation to attend this session today.

4 Antitrust merger review in Canada is governed by
5 the Competition Act that's been -- which came into force in
6 1986. The Act, and in particular, the merger provisions
7 were the result of significant public policy debate within
8 Canada that ran for approximately two decades.

9 Policymakers recognized that effective antitrust
10 legislation had to mitigate anti-competitive behavior but,
11 at the same time, had to be flexible enough to facilitate
12 change in our always, of course, changing economy.

13 Responding to Canada's Economic Council
14 recommendation, the merger provisions were moved from
15 criminal to civil under the Act; and embedded in these
16 merger provisions is a section directing the recognition and
17 evaluation of efficiencies.

18 The Director of Investigation and Research is the
19 official responsible -- or I should say the ultimate or the
20 decisionmaker on mergers and on proposed mergers. He
21 examines mergers and proposed mergers with the help, of
22 course, of the Merger Branch. I head the Merger Branch. So
23 I have the corporate responsibilities of the bureau as well
24 as the Merger Branch.

25 But the director's role is solely investigative.

1 He doesn't adjudicate. Where a merger raises sufficient
2 competition concern, he alone can apply to the Competition
3 Tribunal for a remedial order.

4 The Tribunal is a quasi judicial, administrative
5 tribunal with specialized antitrust expertise. And it
6 operates at arm's length from the Bureau of Competition
7 Policy.

8 The Merger Branch, which I call my branch, is
9 composed of myself, support staff, and about 20 case
10 officers. There's a mixture there of expertise in law,
11 business, and economics.

12 A Department of Justice provides us with legal
13 advice. And often we will go out to seek some further
14 advice in law and business and economics as well.

15 We are very fortunate to have Margaret Sanderson
16 in our division to offer us very sound advice on enforcement
17 economics. She has, I think, a staff of five. So all of
18 the case officers in the bureau do use Miss Sanderson's
19 expertise when we do analyze cases.

20 What we will do, I guess, in the next little while
21 is comment on these slides how we treat efficiencies in the
22 context of merger review.

23 I'll try to provide you some insight on a broader
24 policy context; and then Margaret will speak to the slides
25 dealing with the more technical aspects of efficiencies.

1 We will close, because we know you have a
2 particular interest in this, by maybe looking at the
3 bureau's monitoring program.

4 So I think -- are we a little limited by time?

5 COMMISSIONER AZCUENAGA: Only to the extent that
6 you are. I mean, I think originally you said you -- we can
7 go a little over, yes.

8 MS. MATTE: I saw Margaret's paper outside. So I
9 believe most of you have it.

10 COMMISSIONER AZCUENAGA: Yes.

11 MS. MATTE: It's an excellent paper, by the way.
12 Even I, as a lawyer, can understand it.

13 COMMISSIONER AZCUENAGA: That's a high
14 recommendation.

15 MS. MATTE: Although many countries analyze
16 efficiencies in the area of merger enforcement, I guess
17 Canada occupies a bit of a unique position in that our
18 legislation provides for an explicit efficiency exception to
19 otherwise anti-competitive mergers.

20 Furthermore, our purpose clause under the Act
21 makes it clear that one of the objectives of the Competition
22 Act is to maintain and encourage competition in Canada in
23 order to promote efficiency in the Canadian economy.

24 Before assessing efficiency claims, however, the
25 director, with the assistance of staff from Merger Branch

1 must establish that the merger has, or is likely to,
2 substantially lessen or prevent competition as outlined
3 under Section 92 of the act.

4 I think the test is much the same as you have in
5 the U.S. for the market definition.

6 Where the director believes a substantial
7 lessening or prevention of competition is likely, he will
8 challenge the merger before the Competition Tribunal. Then
9 the parties can raise efficiencies as an exception to the
10 finding by the Tribunal that the merger is likely to be
11 anti-competitive.

12 Under Section 96 of the act, we find all of the
13 needed components to how the test is applied on
14 efficiencies. It requires that the Competition Tribunal not
15 issue an order against a merger where there are likely to be
16 gains in efficiencies that are greater than and will offset
17 the likelihood of anti-competitive effects. These
18 efficiency gains may not be -- could not be attained if an
19 order were made.

20 And I think a very important component is that it
21 provides that it shall not find that a merger -- a proposed
22 merger has brought about, or is likely to bring about, gains
23 in efficiencies by reason only of a redistribution of income
24 between two or more persons.

25 So that's all embedded in Section 96.

1 What's of great interest to you is our total
2 welfare approach.

3 As mentioned, many enforcement agencies analyze
4 efficiencies to determine whether or not to challenge a
5 merger transaction. The essential difference in Canada's
6 approach, in contrast to the U.S., is the adoption of a
7 total welfare standard.

8 When a merger is anti-competitive, it results in a
9 price increase, thereby giving rise to a redistribution
10 effect from consumers to producers and a negative resource
11 allocation effect.

12 A total welfare standard dictates that no weight
13 be accorded to the transfer from consumers to producers,
14 instead, viewing this redistribution as neutral.

15 As a result, a merger will not be prohibited in
16 Canada where it has the effect, or is likely to have the
17 effect, of increasing the sum of producer or consumer
18 surplus.

19 The rationale for the total welfare approach, I
20 think, is firmly grounded in economics and, in the
21 director's view, is also very much embodied in the Canadian
22 legislation.

23 Economists have long advocated treating the wealth
24 transfer effects of mergers neutrally, owing to the
25 difficulty of assigning weights of priority on who is more

1 deserving of a dollar. And even considering that some
2 system of weighing could be articulated, the practical
3 implication of this is likely insurmountable.

4 I think it's difficult to determine who is losing
5 and who is really receiving a transfer. Should we, for
6 instance, differentiate between Canadian shareholders and
7 U.S. shareholders?

8 We have, of course, not much jurisprudence, or we
9 don't have any jurisprudence to support our case. We have
10 -- I guess the one case that has been written -- a lot of
11 things have been said about the Hillsdown case where one of
12 the members, Madame Justice Reed, who has since left the
13 Tribunal, addressed the issue. But it was only an obiter
14 because the Tribunal did not side or did not accept the
15 director's decision that it was actually a substantial
16 lessening of competition in this case.

17 In her discussion, Madame Reed did not offer,
18 however, an alternative legal test but, instead, offered a
19 series of questions which, in her view, should be considered
20 in balancing efficiency gains against expected competition
21 effects.

22 Her concern was that by adopting a total welfare
23 approach to the section, one was narrowing the
24 interpretation to be accorded to anti-competitive effects of
25 a merger.

1 The discussion indicates that Madame Justice Reed
2 finds greater comfort in the U.S. test to efficiencies
3 rather than the one adopted by the director. And so it
4 really departed from the merger guidelines in this respect
5 as well.

6 Given that the efficiencies discussion was obiter,
7 the director did not elect to appeal and the view was that
8 if Parliament's desire had been to deny the possibility of
9 any price impact on consumers by giving consideration to the
10 wealth transfer effects of a merger, then this, presumably,
11 would have been specified in the language of the section.

12 Furthermore, if one believes that prices are not
13 likely to rise post-merger, given the market configuration
14 and the changed cost structure of the firm, then no
15 substantial lessening of competition is likely to rise; and,
16 hence, there is no need to have an efficiency exception.

17 So to require a U.S.-type price test for
18 efficiencies would effectively read the efficiency exception
19 provision out of the Canadian legislation.

20 Despite the more liberal interpretation of an
21 efficiency trade-off, the number of cases is very, very,
22 very small. And I guess Margaret will speak in more detail
23 about different cases that we may have looked at.

24 First, the number of mergers in Canada where
25 significant competition concerns arise is very small. And,

1 second, not all of these transactions involve firms where
2 significant efficiencies were anticipated.

3 Let me just conclude my part of the discussion by
4 saying that no doubt that efficiency claims have become more
5 prevalent in light of the FTA, the NAFTA, as a result of the
6 need to merge in order to rationalize in the face of
7 increasing competition from larger, more efficient U.S.
8 competitors.

9 However, while these claims may have been bona
10 fide, the necessity to weigh them against an SLC has been
11 mitigated by the fact that the markets in question have gone
12 from Canadian to North American and, consequently, the
13 anti-competitive effect of the merger were significantly
14 reduced.

15 Now, I will ask Margaret to continue.

16 MS. SANDERSON: I was going to speak a little more
17 on the details of efficiencies. I will start by talking,
18 first, about what efficiencies would be considered relevant
19 and what efficiencies would we be putting into this
20 trade-off analysis. And a lot of what I'm saying is not
21 very different from the approach that's taking place in the
22 United States by the enforcement agencies.

23 So the first point is that savings have to be
24 savings of real resources. As Francine has already
25 mentioned, they can't be just a redistribution of income.

1 That's actually, specifically, set out in the legislation.
2 But it's an accepted doctrine you can't have pecuniary gains
3 like tax savings count in favor of a transaction.

4 As Francine has also mentioned, the other point is
5 that the efficiencies would not likely be realized if an
6 order against the merger were to be issued. And I'll speak
7 a little bit later on about how we would test for
8 alternatives, what alternative arrangements might be
9 available to a firm to achieve these efficiencies that might
10 be less anti-competitive.

11 There's no threshold in Canada for which
12 efficiencies have to cross to be counted, so it's not the
13 case that there's some minimum number that a firm has to
14 achieve in cost savings in order to have efficiencies be
15 counted in favor of a transaction.

16 One thing that might be of some interest to
17 economists within -- in the U.S. audience is the fact that
18 fixed cost savings are as relevant as variable cost savings
19 in Canada, and that stems from the fact that we have a total
20 welfare approach.

21 And the reason I mention that is that if you have
22 a price standard approach to efficiencies such that you say
23 efficiencies have to be passed onto consumers, prices cannot
24 rise post-merger, in essence, what you're asking is you're
25 asking that the cost savings affect the firm's pricing

1 decision; and that relates to variable costs and to marginal
2 costs.

3 Anyway I'm delving into economics more than maybe
4 I need to.

5 But, in Canada, because we have a total welfare
6 approach, savings in fixed costs would be just as relevant.
7 The idea being that these are still a savings to the firm,
8 they still constitute -- you know, the company saves some
9 money on this area; they can redirect there or divert
10 resources into other areas; and that's ultimately a savings
11 to the economy.

12 These savings that we're talking about are net of
13 any investment costs that the firm might undertake to
14 achieve. So, for instance, if the company is going to make
15 additional changes to a production line and that requires
16 up-front investments, those up-front investments are
17 subtracted from the expected longer-term savings that will
18 result.

19 That will also mean that where you're going to lay
20 people off and there are going to be savings because you
21 have fewer employees, you're going to take the retraining
22 costs or severance pay costs and deduct those out of what
23 you expect to be your savings in employment.

24 So that's the first point.

25 There's two broad categories of efficiencies:

1 production efficiencies and dynamic efficiencies.

2 I'm going to spend most of my time talking about
3 production efficiencies. You've had people that are far
4 more learned in the area of dynamic efficiencies speak to
5 you already earlier today when you were listening to Steven
6 Salop and the other members of this afternoon's panel.

7 I guess one point I would raise up front is that
8 sometimes -- I have read in some of the material that was
9 prepared for this session that there is a general conflict
10 in the idea of, like, how can you have efficiencies be
11 achieved in a competitive marketplace?

12 Truly, if firms have been operating in a way that
13 is minimizing costs in a competitive marketplace, then, you
14 know, a merger might not give you any additional
15 efficiencies.

16 And I guess the point to raise here -- and I'll
17 give a small anecdote in Canada is that, at least in Canada
18 there's been a lot of regulation and a lot of trade barriers
19 in the past. And as a result, given the size of the economy
20 -- and this might also apply to Mexico -- there are a lot of
21 companies that operate below minimum efficient scale.

22 And the example, although an extreme example, that
23 I was going to give you is in the brewing industry. Luckily
24 this regulation is no longer in place. But there was a time
25 in Canada where, to sell beer in a province, you had to brew

1 beer in that province.

2 So the comparison in the United States is that if
3 Coors wants to sell beer in New Hampshire, they have to
4 physically have a brewery in New Hampshire and in Vermont
5 and in Rhode Island and so on and so on. So you can imagine
6 the size and the scale of these production facilities.
7 Highly inefficient.

8 The production efficiencies that we have tended to
9 see the most of are things that I would call plant-level
10 savings, specialization of production facilities,
11 elimination of duplication, reduced downtime, smaller
12 inventories, and the avoidance of capital expenditures.

13 There's also -- we also see a lot of cases where
14 cases are brought forward with efficiencies. Quite
15 frequently, they speak about rationalizing administrative
16 and management functions as well as research and
17 development.

18 You can also have any number of other things here,
19 savings from integrating new activities in the firm,
20 transfer of superior production techniques, know-how within
21 a firm. Although, typically, each management team thinks
22 that it has the superior know-how. So judging, you know,
23 which way the transfer is going is quite frequently
24 difficult if, in fact, it's likely to occur at all.

25 You can have savings in distribution, advertising,

1 capital raising. You can also reduce transaction costs by
2 internalizing functions that were previously contracted out.

3 So those are essentially production efficiencies.

4 The case example that I was going to mention, I
5 was just going to mention two. Hilltdown we've talked
6 about. The Tribunal in that -- the difficulty with that
7 decision is that the Tribunal analyzed the efficiencies and
8 then, as Francine has already mentioned, it was in obiter.
9 So it's difficult to sort of know what kind of weight to
10 give to the analysis they spoke of.

11 But they did point out a couple of things. In the
12 Hilltdown case there were three areas of savings that were
13 discussed: administrative savings, transportation savings,
14 and manufacturing savings.

15 And interestingly enough, the Tribunal did not
16 differentiate between these classes of savings. It wasn't
17 the case that they said manufacturing savings are more
18 important than administrative savings, but each was sort of
19 accorded equal weight.

20 The other example I was going to mention is
21 Imperial Oil. And I was just going to mention this,
22 Imperial Oil bought Texaco Canada when -- I guess the
23 transaction originated in the U.S.

24 Essentially Texaco shed all kinds of assets, I
25 think, in response to various legal liabilities that they

1 ended up -- they were responsible for. And one of the
2 assets that they shed was Texaco Canada. And the spin off
3 of that was a \$4 billion transaction in Canada.

4 One of the interesting things about that case when
5 we were looking at efficiencies is the -- I think it's a
6 good example of the kind of complementarity of assets that
7 can arise between two parties. And what I'm thinking of
8 here is that, you know, in Ontario you had two different
9 refining facilities, a refinery at Sarnia and a refinery at
10 Nanticoke.

11 They had bottlenecks at different points in the
12 production run. And as a result, when you operated the two
13 refineries together, you were able to get yourself around
14 these different bottlenecks. And what that meant was that
15 the parties were able to increase the thru-put.

16 Essentially the capacity was higher if the two
17 refineries were operated together than if they were operated
18 separately.

19 And what that meant was that they could reduce
20 their product purchases, and it increased the volume that
21 they could put forward onto the market. And that could --
22 it also turned out to be the case that they produced a
23 higher value product from the same slate of crude oil.

24 So these are the types of cost savings that were
25 taken into account in looking at that transaction.

1 Dynamic efficiencies, the second broad category,
2 has things like optimal introduction of new products,
3 developing more efficient productive processes, improvement
4 of product quality and service.

5 We've not had many instances that I can think of
6 where these types of savings have been concrete enough,
7 either in the party's minds or in the enforcement agency's
8 mind to be accorded much weight. Traditionally, in the
9 cases that we've had -- as I've already mentioned -- it's
10 really been production savings that have been the main focus
11 of the examination.

12 As I have already mentioned, there is no
13 distinction between different classes of savings, the idea
14 being here that you can just as easily measure, if you're
15 going to combine two head office staffs, what's the savings
16 from that in an administrative or management sense as if
17 you're combining two production facilities and increasing
18 economies of scale.

19 While it's true that each is measurable, it's also
20 true that one type of savings might be more easily
21 verifiable than another type. And so as a result you might
22 accord different weights to different types of cost savings,
23 those which are more easily verifiable, and those that the
24 enforcement agency has greater faith will eventually show up
25 in the market; and, as a result, those are accorded more

1 weight in the analysis that's undertaken.

2 And typically what the Bureau does, which I will
3 turn to, which is sort of how are we going to weigh these
4 efficiencies?

5 But before doing that, I will just mention that
6 the burden for all of this is on the parties. This is
7 rational and certainly the case in the United States. It
8 makes sense to do this because the parties hold the
9 information, a great -- asymmetric information problem, and
10 the enforcement agency has tremendous difficulty in
11 verifying the claims put forward by the parties. So they
12 should bear the burden.

13 The other point I wanted to raise is that, as far
14 as the legal standards, Canada uses a balance of
15 probabilities rather than a clear and convincing standard.

16 So efficiencies, while the parties bear the
17 burden, they'll have to show that, on the balance of
18 probabilities, these efficiencies would go forward.

19 I think the reason that we've not adopted a more
20 stringent standard, such as a clear and convincing evidence
21 standard, is that it's quite possible that -- if you have
22 the burden and you have to show that burden to a clear and
23 convincing standard, that you might, in essence, negate the
24 availability of this efficiency exception. You might never
25 meet your burden.

1 So how do we go about weighing these things?

2 Well, the first thing we do is we usually employ
3 experts. For economic work, we've got economic expertise
4 in-house. Although, we will also, frequently, seek
5 additional expertise from outside.

6 Depending upon the nature of the industry, we will
7 almost -- actually, we will -- if I think of all of the
8 cases we have done this trade off in, we have almost always
9 employed industry experts.

10 So the refining example that I spoke to you about,
11 Imperial Oil and Texaco, the data that was submitted to the
12 Bureau to explain those refining synergies was in the form
13 of a massive linear programming model.

14 Essentially, what the parties did is they used
15 linear programming to model each refinery, what was the
16 optimal output of each refinery and the cost system and so
17 on. And then they designed a new model combining the two.

18 And I mean those of you who remember back to your
19 linear algebra days when you had to solve a two by two
20 matrix, we're talking about something that's 2,000 by 3,000
21 in terms of what this thing looks like.

22 It's solved with a computer. And clearly
23 government bureaucrats, when presented with the computer
24 output, other than saying, yes, it looks like computer
25 output from a linear programming model, can't actually say

1 much more than that.

2 So in that instance it's clearly important to hire
3 people with industry expertise; and we hired a refinery
4 expert, who -- the other beauty of having an industry expert
5 across the table, as well, is I think that that gives the
6 party some signal that they can't, you know, give you stuff
7 that's over the top in terms of it's so far-fetched that it
8 couldn't possibly be true. You've got somebody sitting
9 there that can say, well, this is ridiculous. That would
10 never happen.

11 Original corporate documents are exceedingly
12 important to the analysis. And, obviously, any
13 documentation that is received from the parties prior to
14 consummating -- or not "consummating" the merger -- but
15 prior to the merger discussions is of particular interest to
16 the parties. So, instead of just getting submissions from
17 legal counsel, like yourselves, we're interested in the
18 corporate documents.

19 Experts will also often do independent work, the
20 linear programming that I've talked about, typically an
21 engineer takes a plant tour. That type of thing. And
22 sometimes there's additional economic studies done.

23 In terms of testing the alternatives, there's a
24 couple of things I wanted to mention here. I've obviously
25 talked about the importance of corporate documents.

1 In the case of Hillsgdown, the Competition Tribunal
2 spoke about the fact that they would look to market
3 realities rather than hypothetical instances in terms of
4 determining what alternatives to the merger existed.

5 This is also reflected in our Merger Enforcement
6 Guidelines, in that what we will do in Canada is, we will
7 not discard a cost savings that a party claims on the basis
8 that it could theoretically be achieved by some other means
9 but rather that it would likely be achieved by that other
10 means if we block the transaction or if the Competition
11 Tribunal blocks the transaction.

12 So what that means is that the parties have put
13 forward savings in administration and overhead.

14 In trying to decide if those efficiencies are
15 valid and should be counted in the trade-off analysis, if
16 the corporate documents that the parties have provided
17 indicate that an alternative merger is seriously being
18 considered or that they are planning some contracting out of
19 services, they are not going to manage their own information
20 systems any more, they're going to contract it out to a
21 third party; it's in those instances that we will discard
22 the overhead, administrative savings that the parties put
23 forward.

24 If it's the case that there's theoretically some
25 other merger partner out there that's not, in fact, been

1 identified, those savings -- though it's a theoretical
2 possibility that somebody else could come forward and
3 achieve these same cost savings, in those instances, we're
4 not going to discard the parties' estimates. So the parties
5 are going to -- they'll get the benefit of the doubt in
6 those situations.

7 The types of case examples I just wanted to
8 mention, typically where you're testing alternatives, often
9 the physical location of the assets will determine, you
10 know, whether another party could, in fact, achieve the same
11 efficiencies as the merger partners.

12 So in the brewing example I gave you, clearly if
13 Anheuser-Busch purchased Molson, it would not be possible
14 to have the same kind of rationalization as if Molson and
15 Carling merged together because of the physical location of
16 the plant.

17 In instances where we've discarded efficiencies, I
18 guess there's a couple of things -- I've already mentioned
19 the fact that we've had cases where corporate documents
20 revealed that if not this merger than another merger; and
21 the other merger would be less anti-competitive. In those
22 cases, we will discard cost savings. They won't be relevant
23 for the trade off.

24 Often we've had situations where internal
25 documents revealed that some additional investment was

1 planned without the transaction. And, obviously, in those
2 situations, again, the savings would be discarded.

3 In the case of Hillsdown, there was a fair bit of
4 attention placed on the question of -- a particular facility
5 was closed of one of the merging parties; so a lot of
6 attention was placed on: Was that closed because of the
7 merger? Or was that facility closed for some other reason?

8 In the event that it was closed only for the
9 merger, then the savings that stemmed from that closure
10 would be relevant. In the Tribunal's finding, it was, in
11 fact, evident the fact that the facility would have been
12 closed unilaterally by one of the parties in any event; and,
13 hence, the savings that came from that closure were not
14 relevant to the merger.

15 We have also had situations put forward where the
16 parties have suggested rationalizing their production lines
17 in a way that was physically untenable.

18 So, for instance, they have suggested that what
19 they will do is they will close one particular facility,
20 move the thru-put to the other party's facility, and that
21 way greatly expand capacity utilization rates.

22 And our independent industry expert has been able
23 to say to us: Well, if they do that -- first off, that
24 looks to be physically untenable; there's no plant in North
25 America that runs at that rate of capacity utilization.

1 Alternatively, you can have situations where the
2 industry expert has been able to identify -- all right.
3 Let's say they can increase capacity utilization rates to a
4 particular -- to a particular level but there will be
5 additional costs to doing that from, for instance, increased
6 maintenance costs, because now you're going to have
7 additional breakdown of equipment because it's being run at
8 a rate that is that much higher.

9 We've also had the expert identify the fact that
10 you're now going to have labor operating at times when they
11 have to pay overtime, double time, double time and a half,
12 whatever. And because of that, we have to factor in higher
13 labor costs as well as the fact that there will be some cost
14 savings from increasing capacity of utilization rates.

15 As I've already mentioned, the legal standard is a
16 balance of probabilities; and the only other point I would
17 raise here is the fact that, while it's certainly difficult
18 to estimate cost savings and synergies that come from
19 mergers, it's been the Canadian experience that it has not,
20 inherently, been that much more difficult than estimating
21 the competitive market situation. It's not that much more
22 difficult than trying to get a handle on potential entrants
23 or what is the competitive response going to be of
24 particular rivals?

25 Any merger analysis is forward looking. Any

1 merger analysis will involve some degree of speculation.
2 The notion here is that efficiencies analysis is not any -
3 it's not that much more speculative, at least on the
4 production side, than other areas of the competitive effects
5 analysis.

6 The trade offs, as Francine has already mentioned,
7 is the fact that the efficiencies have to be greater than an
8 off-set of the anti-competitive effects of the transaction.

9 So we've now gone through the cost savings that
10 the parties have put forward; we've used a number of means
11 to try and verify the size of those; we've tested to find
12 out if there are alternatives to them; we have a number at
13 the end of that analysis.

14 That number is given a probability weighing. That
15 number is put into present value terms. Typically, cost
16 savings accrue after initial upfront investments. So you
17 want to take account of those initial upfront investments.
18 So you get a number on one side of the equation at the end
19 of the day.

20 The anti-competitive effects, as Francine has
21 already mentioned, do not include the wealth transfer from
22 consumers to producers.

23 What that means is that you can have a merger in
24 Canada that increases prices but is still found to be
25 socially beneficial.

1 I think a lot of the reluctance to adopt this type
2 of approach stems from, perhaps, too narrow a reading of,
3 really, Oliver Williamson's original work. And one of the
4 things that Oliver Williamson found in his original
5 discussion in this is that you could have very small savings
6 in costs, large price effects. And I mean, that's just not
7 what competition agencies want to hear.

8 But Oliver Williamson also pointed out that this
9 was a simplified analysis. He called it a naive trade-off
10 model. There were many other things he pointed to that you
11 had to do to expand the analysis to make it relevant to the
12 real world. There might be pre-existing market power,
13 market power clearly extends across the industry. It isn't
14 just on these firms. Yet the cost savings were specific to
15 these firms.

16 There's differing demand assumptions that can be
17 made about how the market performs, differing assumptions of
18 competitive interaction. So one has to have a fuller
19 modelling of the cost conditions and the demand side of the
20 equation.

21 Economists like to think they can do this. And
22 so, essentially, how we have done this in Canada is to try
23 and get a handle on the anti-competitive effects, various
24 demand elasticities where assumptions are used, various
25 pricing and output scenarios are put forward; and

1 essentially a series or a table of losses are calculated for
2 different pricing scenarios.

3 And at the end of the day, you have some figure --
4 a table of losses, and you have some efficiency cost number
5 that you're looking at. And, normally, how this proceeds is
6 -- at least in the cases that I've been involved -- one
7 turns to asking, okay, the particular table reveals that in
8 this situation you need a 20 percent price increase to swamp
9 these cost savings.

10 So then you ask: How likely do I think a 20
11 percent price increase is? If the product is -- faces a
12 very inelastic demand, there are few substitutes, it's
13 possible that you could envision a 20 percent price
14 increase. And you might then say, you know, it's too close
15 for comfort.

16 More often, what tends to happen is we're dealing
17 with price increases that are sort of in the 5 percent
18 range, 5 to 10 percent range.

19 One piece of economic literature that I think is
20 interesting to this debate and is something that perhaps
21 should be pursued to greater length is there's a notion that
22 perhaps you could use the wealth transfer to the merging
23 parties as some kind of signal of the credibility to be
24 given to efficiency claims.

25 And the notion here is that economic theory tells

1 you that, on average, mergers should be marginally
2 profitable. It shouldn't be highly profitable or highly
3 unprofitable, the notion being that if they're highly,
4 highly profitable, why didn't they happen earlier? So, you
5 know, this is what theory would lead you to believe.

6 Taking that together with the fact that we know
7 that mergers will increase profits either through market
8 power effects or through cost savings, you can ask yourself,
9 in a situation where you think the market power effects are
10 going to be great, you believe that there's going to be a
11 large price increase and there's going to be a lot of wealth
12 transferred to the merging parties as a result of that, that
13 is -- so far, it's been explained to me that it's going to
14 be a highly profitable transaction. If they're also coming
15 forward and saying there's going to be these massive
16 efficiency gains at the same time, then you're talking about
17 a dramatic increase in profitability.

18 Theory might suggest that that's not necessarily
19 going to happen. The empirical studies on merger activity
20 are quite mixed as to how profitable mergers are.

21 If one were to adopt this type of analysis, then
22 I'm not saying that where you think there are going to be
23 large price increases and parties are going to be made quite
24 wealthy as a result of that, that you're going to
25 necessarily drop any consideration of efficiencies.

1 Clearly, if you did that in Canada, you would be
2 dropping efficiencies at the very point in time where the
3 legislation felt that they were needed, because we do have
4 an efficiency exception.

5 However, it might point you, the enforcement
6 agency, to carefully scrutinizing where those cost savings
7 are coming from and how likely you think they actually might
8 be.

9 If you think -- if you have a market where most of
10 the competition is non-price, in service, variety, quality,
11 research, innovation, this type of analysis is not relevant.
12 This type of trade-off analysis that I'm talking about is
13 really a quantitative analysis. It's very, very difficult
14 to do it in a qualitative sense.

15 The second point here about relevant markets is
16 that, because we have a total welfare approach, we can have
17 cost savings in markets other than the market for which we
18 have competition concerns included in our trade-off
19 analysis, with one caveat.

20 The legislation specifies that the savings would
21 not likely occur if the order were made. So if you had a
22 partial divestiture order situation and you had -- so you
23 had a company that produced Product A and Product B, and the
24 order you were seeking was to divest facilities related to
25 Product A, because that's where the competition concerns

1 were, then if cost savings show up in Product B, you're not
2 -- they're not relevant for this trade off.

3 Except -- I have an exception to my exception --
4 except if it were found that the cost savings related to
5 Product B are somehow inextricably linked to those where the
6 competition problem is. So that if I challenged where the
7 competition problem is, these savings would not be achieved.

8 And it's in that context that we will cross --
9 we'll have savings crossover markets.

10 All of the -- I want to sort of close some of this
11 by saying that it's clear -- I don't want to leave the
12 impression that this is an exact science. We do -- we spend
13 a tremendous amount of time trying to verify actual claims.
14 And we get quite good data on it and are able, I think, to
15 do a fairly decent job of verifying and having some notion
16 of where we think cost savings will come from.

17 But it's not the case that we're going to go down
18 to such a fine degree that if the cost savings are \$30
19 million and the anti-competitive effect is \$30 million minus
20 a dollar -- or \$29 million dollars, that that is going to --
21 that transaction will be allowed to proceed.

22 What we're trying to do here is we're trying to
23 compare orders of magnitude. There's obviously a lot of
24 discretion used at various stages. There is a tremendous
25 amount of discretion in choosing what you think the

1 anti-competitive effects are, what you think the demand
2 assumptions are, what you think the competitive interaction
3 assumptions are.

4 There's also a lot of discretion used by the
5 enforcement agency on issues like probability weightings,
6 how likely do I think these cost savings are. And that type
7 of thing.

8 So that was what I was going to say about the
9 technical side of the efficiency analysis. And we thought
10 we would close with the monitoring program.

11 MS. MATTE: Now you understand why I accompany
12 Margaret and her not me and how the Bureau relies so much on
13 her expertise and on her division and on the officers
14 comprising this section.

15 You may have a lot of questions on Ms. Sanderson's
16 paper or comments. I will provide you just general comments
17 on a review process, because I think it might be of interest
18 to you, Mr. Chairman.

19 We have a statutory, three-year window for the
20 director to challenge a merger before the Competition
21 Tribunal. And, of course, we will often be using that
22 window to monitor mergers or transactions.

23 So we're looking, basically, at two categories of
24 transactions, the borderline ones where you have high market
25 shares and where you have -- where you have weighed your

1 factors under Section 93 and the barriers and the remaining
2 competition.

3 And also where we have some concerns that
4 efficiencies may not materialize so this is what we call
5 borderline ones.

6 And then we look, of course -- we monitor,
7 automatically, the contested ones. We also, of course, will
8 monitor where we will be called upon to arrive at some
9 resolution pre- -- where we arrive at some pre-restructuring
10 before the closing of the merger, after -- either through
11 undertakings or through consent orders.

12 So, basically, I know, you're probably more
13 interested in the efficiency review if that takes place. As
14 mentioned initially, we have no case law or no tangible
15 examples of finding a substantial lessening or prevention of
16 competition and then going to efficiencies. But I wouldn't
17 want to leave the impression that we never look at
18 efficiencies.

19 The other comment maybe I would like to make is
20 that monitoring becomes, of course, very costly. With the
21 shrinking of our resources, it is something that may be more
22 and more difficult to achieve effectively. But certainly it
23 is in place, and we are looking at it.

24 Now, of course, we rely a lot on information
25 provided by the parties and will often try to get

1 third-party information in the process.

2 That, of course, raises issues of confidentiality;
3 and we've always attempted to provide comfort to the parties
4 that, yes, indeed, we would keep the information
5 confidential but within this three-year window.

6 It has happened, I think -- I'm not sure,
7 Margaret, whether you can attest to that -- but on some of
8 the cases maybe under review, we have expanded the
9 three-year window through an agreement with the parties. So
10 we were able to monitor later on. So, I don't know, maybe
11 one thing that might be of interest to you, when I mentioned
12 that the director was the sole -- he could only bring
13 matters before the Tribunal.

14 The only instance where a person might bring a
15 matter before the Tribunal is when there has been a
16 contravention of a consent order involving a merger where
17 that person may have suffered some loss or damage.

18 So, Margaret, would you like to add anything on
19 our monitoring of efficiencies? If there were a couple of
20 cases, maybe you would --

21 MS. SANDERSON: Yeah. I can just indicate that,
22 as Francine has mentioned, we have used the monitoring
23 program in a couple of situations where the competition
24 concerns have been borderline. It's been unclear whether or
25 not substantial -- the lessening of competition that could

1 potentially result from the merger would be substantial or
2 not.

3 In a couple of those cases, the parties brought
4 forward efficiency claims. And in a couple of those cases,
5 we proceeded to monitor the achievement of those
6 efficiencies in addition to monitoring other things going on
7 in the market at the time.

8 The two cases that I was going to mention, one is
9 the glass industry, Consumers Packaging purchased Dom Glass.
10 They were the two major producers of glass containers in
11 Canada. And they were anticipating fairly significant
12 savings from production and operational cost reductions.

13 Essentially, the order of magnitude was about 54
14 million Canadian dollars per annum. And that represented 10
15 percent of the parties' combined 1988 sales.

16 As part of the monitoring program, the parties
17 retained an independent third-party who provided a report to
18 the Bureau sort of -- I think it was two years after the
19 close of the transaction. That was the point in time which
20 most of the efficiencies would be achieved. In fact, the
21 report did indicate and was verified by the Bureau to
22 indicate that, while it took a little longer for them to
23 achieve the efficiencies, they did, in fact, achieve the
24 vast majority of what they had expected.

25 The other case where we had a more extensive

1 monitoring program involves the brewing industry that I
2 spoke about, Molson and Carling merged their operations.

3 And as a result of that transaction, and as I
4 alluded to earlier, the highly inefficient nature of the
5 brewing industry beforehand, the parties were able to close
6 over seven brewing facilities and also achieved quite a
7 large number of reductions of administrative and overhead
8 management functions.

9 They also made a number of capital expenditures in
10 the remaining breweries. And as a result, they achieved
11 over 200 million in annual operating cost savings as a
12 result of the transaction.

13 The monitoring program that was implemented in
14 that situation, the parties were required to submit
15 quarterly reports to the Bureau of Competition Policy on a
16 wide variety of matters. There was, obviously -- quite a
17 bit of detailed information was submitted about these plant
18 closings, the timing, the nature of the capital expenditure
19 investments and so on.

20 There was also, at the time -- the Canadian
21 brewing industry is highly -- it's fairly highly regulated.
22 And so there were a number of changes in government
23 regulation and some other things going on in the marketplace
24 that were also being monitored at the same time.

25 And I guess the only other point I would close on

1 is that monitoring programs, I think -- they're a bit of a
2 difficult thing in the context that they can give you quite
3 a lot of information. There's some, I think, inherent
4 tension within our organization about the extent to which we
5 can use them.

6 The danger, of course, is that you become a
7 regulator. And traditionally, one of the problems with
8 becoming a regulator is that you get all of the complaints.
9 And, as Francine has mentioned, you don't often want all the
10 complaints. You know, I don't want to become the new
11 telecommunications regulator, or the new brewing regulator.
12 I would much rather have somebody else fill that function.

13 Also the competition agency doesn't have the tools
14 that are available to regulators sometimes. So there is
15 some difficulty in that context.

16 And I guess the only other difficulty that we face
17 in these -- when we pursued efficiencies in this context is
18 that if we go ahead and with the conditional clearance of a
19 transaction based on achieving some efficiency gains, you
20 have to be able to credibly threaten the parties that if
21 they don't achieve those gains, you're going to do
22 something; you're going to break this merger apart,
23 challenge it.

24 And that may be very difficult to threaten to do
25 when the parties have significantly combined their assets in

1 order to achieve the efficiencies.

2 So you can be in somewhat of a Catch-22 situation.
3 You can also imagine a situation where the enforcement
4 agency wants to maintain or enhance its ability to make this
5 credible threat and so it wants certain assets held --
6 traditionally we do that by hold separate agreements, you
7 know, holding the Crown Jewels separate and so on, in the
8 event that there's a problem, we then have a stick to say,
9 well, this is the divestiture that's required. You can
10 imagine situations where you, as the enforcement agency,
11 choose to do that; but that, then, inhibits the realization
12 of the efficiencies.

13 Essentially, we wanted just to close on that note.

14 Thank you.

15 MS. MATTE: I will just add that, yes, indeed,
16 we're interested in getting all the business of
17 deregulation; but we would want the resources accompanying
18 this; so we've made the pitch very often.

19 COMMISSIONER AZCUENAGA: Well, thank you. I
20 thought that was a very clear, very thoughtful and very
21 useful explanation of your policies and procedures; and you
22 have a wealth of experience to share. I found it very
23 interesting.

24 I'm not going to ask any questions because I
25 suspect there are others here who may have some.

1 CHAIRMAN PITOFSKY: I know the hour is late, but
2 let me very briefly ask two questions. And I apologize for
3 not having been here earlier. Perhaps, you addressed this.

4 First, it's commonly said in the United States
5 that efficiency claims are so amorphous, the evidence is so
6 soft that you really can't deal with it. You've had more
7 experience than almost any other country in dealing with
8 efficiency claims. Is that your reaction, that at the end
9 of the day, you feel that you're dealing with claims that
10 are very difficult to verify?

11 MS. SANDERSON: No. I think that companies have a
12 fairly good idea up front. I take the example of head
13 office staffs. We need one accountant; we don't need two
14 accountants. We need one retail sales manager; we don't
15 need two. We need 16 sales staff, not 20.

16 And so in terms of that kind of a measurement,
17 that's often quite easy to predict.

18 Other things are slightly more difficult, these
19 types of synergies that we've talked about between
20 facilities. And I guess the one -- traditionally, the
21 Bureau has received quite detailed cost information in order
22 to verify these gains.

23 And the one problem -- or one of the potential
24 problems with that is you don't actually want to have a
25 tremendous amount of detailed cost information be directly

1 exchanged between the parties to give you these figures in
2 the event that if the transaction collapses for some reason,
3 they're now exposed to criminal sanctions under the
4 conspiracy provisions.

5 And so, traditionally, how this -- alternatively,
6 you might, as the enforcement agency, also not want to have
7 a situation where parties are bringing mergers forward as a
8 sham for some type of a conspiracy.

9 So how we tried to handle that on the cost side
10 is, at least the more experienced legal counsel have
11 traditionally hired an independent expert where that's the
12 person, or that team of people, are the people who get the
13 two sides of cost information. So that hasn't always been
14 the case. This linear programming business that I spoke
15 about where the parties -- there was a small group of people
16 in each firm that had an awful lot of information about the
17 cost effectiveness of their rival.

18 That is quite a danger, I think, when you go this
19 route, because you do need to get very detailed information.
20 And the parties have to exchange very detailed information
21 in order to get some notion as to what the gains would be.
22 Indeed, the numbers that come through are very, very
23 specific.

24 Now, we don't normally get into that type -- we
25 don't get those numbers up front, obviously. It's only once

1 the agency has said: I think there's going to be a serious
2 competition problem here that the parties scramble fast and
3 come up with an efficiency story.

4 Perhaps that might explain why you maybe haven't
5 had the same detail of cost information come forward, is
6 that, you know, the parties just back off right away in the
7 event that they face a challenge from the enforcement
8 agency. And so they just don't bother putting their heads
9 around some of the cost information.

10 When they do put their heads around it, they
11 provide very detailed information.

12 CHAIRMAN PITOFSKY: Thank you. You have answered
13 my second question with that answer.

14 COMMISSIONER AZCUENAGA: I just have a quick
15 question. We actually do get fairly detailed efficiency
16 justifications sometimes.

17 But what sometimes happens is that, you know, when
18 our economists examine them, they find them to be
19 unreliable.

20 Is that ever your experience?

21 MS. SANDERSON: Oh, yes. Oh, yes. I mean, I can
22 think of one situation where -- I mean, the parties will
23 choose the figures to their advantage, which, you know,
24 economic theory tells you they should; we should all act in
25 our own self-interest.

1 So they will -- depending upon the cost figure
2 that's used, you can come up with quite different estimates
3 for different types of savings.

4 And so I can think of one case where we did
5 discard a lot of the efficiency story that was put forward
6 because other documentation that the parties had relied upon
7 had quite different cost figures. And when you recalculated
8 some of the savings using those other figures, you got quite
9 different numbers.

10 I've also -- I can also think of a case where the
11 parties were going to form a -- they were going to form a
12 joint marketing distribution function, so they were going to
13 do some production rationalization and then jointly market
14 and distribute a particular product. And they were claiming
15 cost savings in administration and overhead.

16 And what we found is that they were moving the
17 same number of employees to this new function, new entity
18 that was going to jointly market with them; yet for some
19 reason the cost per employee was 51 percent of what the
20 former entity was.

21 So if you took the salaries, the benefits, and a
22 number of other things, in their pre-merger, the cost per
23 employee was 140,000 Canadian; and then post-merger, the
24 same number of people, are now, at a per-employ cost --
25 salaries, benefits, and so on -- for some reason these

1 numbers come out to show that it's 51 percent of the old
2 number.

3 Well, I don't think the people going to the new
4 agency realized that their salaries and their benefits are
5 going to be cut by that, you know, in half. So where does
6 this number come from?

7 And often once you start engaging in a dialogue
8 with the parties about these numbers, if there's anything
9 that's a little fishy, inevitably, they back off.

10 MS. VALENTINE: I guess one quick question.

11 Sorry. It is late.

12 Are you finding, then, generally, that the
13 efficiencies can be made specific enough that you do not --
14 I realize you don't need to monitor because usually you're
15 not assigning substantial lessening of competition; and,
16 therefore, you're not getting into the balancing of the
17 efficiencies -- but that you sense it wouldn't be your need
18 to conditionally clear something and then monitor it, that
19 you actually could make the assessment up front?

20 MS. SANDERSON: I mean, we would try to make the
21 assessment up front. We have, I guess, to some extent, the
22 luxury of this monitoring program in the event that we did
23 decide to, for some reason, to make that projection up
24 front. We could proceed to monitor to see what would happen
25 after the fact.

1 If you can -- nobody likes, really -- I can't
2 really think of too many competition or antitrust
3 authorities that are too crazy about the idea of monitoring,
4 you know, because after the transaction, the parties can
5 engage in all kinds of strategic behavior that they -- they
6 could decide not to increase prices for three years and just
7 wait until the three-year review period is up.

8 So there's a lot of things that they could do that
9 if we can avoid that course of action we would.

10 Where we haven't been able to, we've certainly
11 made use of it.

12 COMMISSIONER AZCUENAGA: Well, thank you all very
13 much.

14 (Whereupon, at 4:58 p.m., the hearing was
15 recessed.)

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C E R T I F I C A T E

DOCKET/FILE NUMBER: P951201
CASE TITLE: GLOBAL AND INNOVATION-BASED COMPETITION
HEARING DATE: November 2, 1995

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above cause before the FEDERAL TRADE COMMISSION to the best of my knowledge and belief.

DATED: November 2, 1995

SIGNATURE OF REPORTER

GREGG J. POSS
(NAME OF REPORTER - TYPED)