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3 FEDERAL TRADE COMMISSION

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6 MERGER WORKSHOP

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20 Washington, D.C.

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23 Reported by: Rita M. Hemphill, C.V.R.

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1 **P R O C E E D I N G S**

2 **WELCOME**

3 MS. CALLISON: This is the second day of the
4 Joint DOJ/FTC Workshop on Merger Enforcement. Yesterday
5 contained a lot of interesting information and useful
6 panels. I'm sure today we will follow that up quite
7 well.

8 I want to let you know that presentation
9 materials from our panelists' papers and slide shows that
10 they have sent in will be available on our respective web
11 sites. I wouldn't look for them on Friday, but they will
12 be there shortly. Likewise, the transcripts of the
13 hearings of the workshop will be available on the web
14 sites at some future date.

15 Thank you.

16 **NON-PRICE COMPETITION/INNOVATION**

17 MR. FRANKENA: This morning we will be focusing
18 on the discussion of the effects of mergers on
19 innovation. Our panel today is Steve Sunshine, who will
20 speak first, and then Ann Malester will go next, and then
21 Dick Rapp, and after that, we will have an open
22 discussion between the panelists and the audience, with
23 audience participation and so forth.

24 When I was asked to moderate this distinguished
25 attorney and economist panel on mergers and innovation,

1 my first thought was to seek input from the investor
2 community which didn't seem to be represented.
3 So I asked my friend Tom, who after all has
4 about 1,000 patents, whether he could address the
5 relationship between competition and innovation this
6 morning. Well, Tom couldn't join us, but he reminded me
7 that he had addressed this very matter back in 1889, when
8 someone proposed that his firm, Edison General Electric
9 and its competitor, Westinghouse Electric call a truce in
10 their war to sell electric systems to cities and towns
11 around the country.
12 Tom explained that he refused to go along with
13 the proposal because, and I now quote from a contemporary
14 letter from Edison: "If we make the coalition, my
15 usefulness as an inventor is gone. My service wouldn't
16 be worth a penny. I can only invent under thought of
17 incentive. No competition means no innovation."
18 But my real difficulty with this statement,
19 though I -- after I read it I noticed that it was written
20 on April Fool's Day in 1889, so I don't know how much
21 weight to put on it, but that's a statement from an
22 important inventor.
23 Okay. With that, could I ask Steve to get us
24 started?
25 MR. SUNSHINE: Thank you. I'm happy to be here

1 this morning. I was not supposed to be the lead-off
2 speaker. The lead-off speaker was the distinguished
3 Professor Davis. He ate some bad fish yesterday and,
4 therefore, could not be with us. It seemed like a rather
5 extreme way to get out of doing this talk, but I did last
6 night consider that.
7 I struggled for how to title this talk, and
8 like everything else, the inspiration came to me because
9 of something my 12-year-old son did. I was listening to
10 this song by Smashmouth called "All Star," which I'm sure
11 you all have heard. Don't worry. I'm not going to sing
12 it for you.
13 There is a line in there that says, "I'm not
14 the sharpest tool in the shed." To me, the parallels
15 between that and innovation analysis were just
16 immediately obvious, as I'm they are to everyone sitting
17 here in the room.
18 The point that I will make generally today is
19 that innovation analysis has its uses. I wouldn't call
20 it the sharpest tool in the shed. That leads to the
21 question, and hence the title, when should this tool come
22 out of the shed?
23 Just as an overview, I hope that these
24 propositions here are pretty non-controversial, at least
25 the first few ones are.

1 Innovation is an important dimensional rivalry
2 and intervention of progress. I don't think there's a
3 lot of dispute for this point. I think the studies that
4 have been done over time have said that innovation has
5 been responsible for the vast majority of economic
6 progress that has been made over the last century.
7 Then when we try to actually apply it to merger
8 analysis, can we actually predict the effect of a merger
9 on innovation? We will talk more about this later. I
10 think it's fair to say that the effects are uncertain.
11 Of course, it's probably also fair to say that the
12 effects of market structure on goods and on the
13 relationship between market performance on goods is not
14 as clear as we would like it to be as well.
15 That leads me to this is, I think, where we get
16 a little bit more into my view, and others clearly have
17 different views, the legal and economic issues. There
18 are legal issues here, too. We have been focusing mainly
19 on the economics, but there are legal issues here, too,
20 that legal and economic issues require a showing -- I
21 called it "probable effect on output." When I say
22 "output" here, I don't mean innovation output. I mean
23 output in the goods market.
24 The Genzyme example, we will get to it, we all
25 have our views on it, but perhaps Genzyme is an example

1 where the chairman and the rest of the Commission
2 basically followed the first three bullet points, thought
3 in theory there could be an effect on innovation, but
4 found a set of facts where the merger could not have a
5 demonstrative effect on output, and hence, no case. If
6 that's what they did, count me in. Of course, the facts,
7 we have to talk about.
8 Lastly, just in terms of what does this mean
9 practically? My general point on this is going to be
10 that the practical application of innovation markets is
11 infrequent. We are not going to see a lot of innovation
12 market cases. They are more likely in certain
13 industries, pharmaceuticals being the obvious example,
14 and that for reasons that I think some of my co-panelists
15 will go into.
16 One of the many big problems with innovation
17 markets is that they are really hard to define. How do
18 you know an innovation market? We'd like to see a
19 standard more than just as spotters, you know, I'll know
20 it when I see it.
21 We have to account for trying to identify all
22 the conceivable sources of innovation. We have to
23 account for how do we know what the strengths and
24 significance of the population of innovators are.
25 Also, the type of innovation that's going on in

1 the market may be relevant to our confidence in market
2 boundaries. What do I mean?
3 Well, are there regulatory barriers that are
4 going to make innovation much more structured? Is
5 innovation tied to certain sets of production assets,
6 where we know that people without production assets
7 really are not effective innovators?
8 For that, I would refer to the Department of
9 Justice's complaint in the General Motors/ZF
10 Friederichshafen case. That case of innovation was tied
11 to an existing set of production assets, and no one could
12 innovate new truck and bus transmissions unless they had
13 those set of processes.
14 Then another way or type of innovation is
15 patents, but patents are really tricky. When you get to
16 patents, patents may mean there are a necessary set of
17 assets. It may also mean that markets have been divided
18 up so that the mergers are complimentary. You have to be
19 really careful.
20 I won't go through the article that Professor
21 Gilbert and I wrote, but we identify certain sets of
22 factors that you need to find in order to have some
23 confidence that you have an innovation market. If you
24 don't have that kind of confidence, then frankly you
25 should go home at that point. If you can't define the

1 market and you can't define a few players, there's no
2 point in going on. If you can, of course, there's more
3 work to do.
4 Defining the boundaries of the market is hard.
5 This part is even harder. How can you actually predict
6 the competitive effects? How can you assess the merger's
7 effect on innovation and then translate that into an
8 output effect?
9 We start off with, I think, a very obvious
10 question, structures as a means of predicting
11 performance. Who is right, Schumpeter or Arrow?
12 Schumpeter basically says you need monopoly
13 rents, and it's possible in some industries you may need
14 monopoly rents to actually provide incentives for
15 innovation. Arrow says, on the other hand, because of
16 cannibalization concerns, expected return, that perhaps
17 monopolists do not have the same incentive to innovate at
18 the same rate as others.
19 I don't think it's fair to say the economics
20 literature thinks this is completely an unaddressed
21 question. There has been a lot of work done by Scherer,
22 by Spence, by Stidless, that allows you to make some
23 inferences. It's certainly not proven.
24 I think, also, if you go with just basic
25 intuition, how many around this room believe that time

1 after time, monopolists really have a high incentive to
2 innovate?
3 I think it is fair to say that just as a matter
4 of economics, we don't know for sure what the answer to
5 that question is. We might have an intuition. We may
6 have our own belief, but we don't know.
7 That leads us right into the second issue,
8 which is the problem of the necessity of case specific
9 evidence. I think, given the uncertainty in the
10 economics, that all of these cases have to be driven by
11 the actual facts of what's in front of the Commission,
12 what's in front of the DOJ, what's in front of the
13 plaintiff. You have to believe there is important
14 innovation competition going on between the two, and that
15 each have high incentives to innovate.
16 Again, the GM/ZF case, I guess I have a little
17 familiarity with, was a case where the evidentiary record
18 showed years and years of the two companies actively
19 targeting each other's innovation activities, actively
20 pursuing incremental process improvements, and then with
21 the signing of their merger agreement, saying we're not
22 going to do this so much any more, but then labeling it
23 efficiency.
24 That was a fact specific inquiry that led to
25 say, you know, I think we know enough. Maybe Schumpeter

1 is right sometimes. Maybe Arrow is right sometimes, but
2 we are now in the Arrow camp with these facts.
3 I touched on incremental versus revolutionary.
4 This is an idea of how big the innovation is. In some
5 ways, incremental innovations may be the ones that are a
6 little bit easier to understand how to protect. It may
7 be easier to define where the sources of that innovation
8 are going to come from. These revolutionary innovations,
9 there's much more profit at stake, so there's more
10 incentive to pursue them, and sometimes they are harder
11 to tell where they are going to come from, what the
12 source of that innovation is going to be.
13 In the incentives, I don't think you could
14 understand the incentives to innovate until you
15 understand the nature of competition between the
16 innovations. That's going to require looking back at the
17 downstream level.
18 Are two pharmaceutical companies going to be
19 manufacturing exactly the same chemical compound that,
20 you know, once they get to the market, they are going to
21 be in competition with one another, and there's no orphan
22 drug status. You know, once they get to the market, they
23 will be in competition with one another.
24 That may lead you to one set of conclusions.
25 If on the other hand these products are so sufficiently

1 different they are going to be attacking different
2 markets and there will be a high expected return, maybe
3 there will be an incentive for both products to be
4 developed. I don't know. Maybe the second invention is
5 going to open up so many new applications and increase
6 demand that there will still be a strong incentive to
7 invest.
8 Confidence that the reduction in innovation
9 will lead to an output effect. That goes to all the
10 previous statements, too, but here, I think you have to
11 take into account downstream competition. What if there
12 are downstream products that are competing against your
13 upstream products, and those are going to continue to
14 spur innovation.
15 I think that what all this is saying is that
16 there are a lot of steps to go through in order to get to
17 this level of confidence. Lastly, I put down here, is
18 the effect outweighed by innovation efficiencies?
19 Let me just throw in a point just as a matter
20 of personal opinion. I know this is not necessarily
21 accepted by everybody. One of my pet peeves is this
22 whole idea of merger specific efficiencies. People,
23 after the fact, sitting around and saying gosh, I think
24 these guys probably could have done a contract research
25 and development joint venture. To me, that is a naive

1 view.

2 I think the analysis should be here's the deal,
3 here's what life would be like absent the deal, and is
4 the world a better place or not, but to try to social
5 engineer efficiencies seems to me to be a misguided
6 approach.

7 What I've done by putting efficiencies as part
8 of the competitive effects, I haven't shifted the burden
9 of the efficiencies to the defendants. I think it is
10 still part of showing -- to show an output effect.
11 Eventually, this really belongs in the camp of the
12 plaintiff, because you can't show the effects unless the
13 efficiencies don't outweigh the other benefits.

14 Enough about economics. What about the law?
15 I'm running behind.

16 There have been a lot of consent decrees.
17 There has been a complaint that the Department of Justice
18 filed that did not go to trial. There have been some
19 other cases where innovation is sort of talked about but
20 not a true innovation market.

21 Does Section 7 really allow us to have an
22 innovation market? The few cases that exist on this, I
23 think, say that without actual sales and a line of
24 commerce, that perhaps you don't have a market, which if
25 that was true, that would doom Section 7 analysis.

1 That's my view, and what Gilbert and I wrote in
2 our articles is that it would be misplaced for Section 7
3 to not recognize an innovation market theory. The reason
4 why I say that, we would start from, I think, a pretty
5 easy proposition that says that merger analysis should be
6 designed to identify those mergers that lead to reduction
7 in welfare, to lower output.
8 The analysis that I just went through, if you
9 can go through that analysis and come to the conclusion
10 that output is reduced, you have satisfied what is the
11 basic condition. Then the question on an innovation
12 market, I think, is the innovation market essentially
13 identifies the place of competitive interaction where the
14 problem arises, and then the output market actually
15 defines where the effect is felt, and it defines the line
16 of commerce and the section of the country that the law
17 is trying to protect.
18 In that way, I would draw a loose analogy, and
19 it's not a perfect analogy, to a vertical merger. In the
20 actual output market, there's no direct effect. You
21 could look at input, you could look at innovation as an
22 input or an upstream product in a vertical merger, but I
23 would say if you look at the Medicorp vs. Humanas case
24 and some of the other cases cited in the stuff that we
25 wrote, there are some courts that have gone other ways,

1 because they are thinking cookie cutter, define a market,
2 measure the market shares, prima facie case, blah, blah,
3 blah. That's one way of doing it.
4 The second point, can plaintiff prove a
5 non-speculative effect in a reasonable amount of time? I
6 think that proposition stands for itself. This would be
7 a defense that I would want if I was defending against an
8 individual market case. This just goes back to the
9 importance of being able to actually have the documents,
10 the market evidence, and everything else to show that
11 this is a real problem.
12 I know I'm running short and I want to leave
13 time for some conversation. I won't spend much time on
14 this.
15 Ron Davis, who was going to lead off, was going
16 to say burdens, where's the beef? I was going to say,
17 why all the fuss? The burden of proof is always on the
18 plaintiff. We all know that. We know that PNB and Baker
19 Hughes say that upon the establishment of a prima facie
20 case, that the burden of production shifts over to the
21 defendant, but the burden of persuasion always remains
22 with the plaintiff.
23 I think in the Genzyme case, while it was just
24 an investigation, it wasn't a case, I have to imagine
25 that the defendants satisfied a burden of coming forward

1 with evidence.
2 It seems to me that any proper application of
3 this kind of analysis would lead to the burden going back
4 to the plaintiff to persuade they were actually right.
5 If Commissioner Thompson's dissenting opinion
6 means something else, with a presumption, then he means
7 something else, which I think is not in step with the
8 case law, perhaps even for output markets, but certainly
9 not for innovation markets for the reasons that we have
10 talked about.
11 Problems of the investigator. The first point,
12 I think, is obvious to everybody sitting in this room.
13 The investigator has a duty to evaluate the transaction
14 before it. In the transaction before you, if you see
15 serious competition in innovation, what are you going to
16 do? You have a duty to look at it. You don't want to
17 just let the transaction go if you think there is going
18 to be a problem. You have to dig in.
19 The law with the state of the economics, there
20 is no easy path here, is there? We have just been
21 through it. I think the burden of proof, while there
22 could be some adjustments, depending on who is involved,
23 the burden of proof is clearly going to be on the
24 plaintiff, and the plaintiff and the investigator will
25 have to show a number of difficult issues. Innovation

1 space which will occur, the merger's likely effect on
2 innovation, the manner in which output will be reduced,
3 and again, output is output in a goods market, and when
4 the output effect will be felt. Not easy stuff, right?
5 We are talking about doing this in at least two
6 different markets, two different spaces.
7 Again, as sort of the last resort of the
8 investigator, the importance of empirical evidence from
9 the merging parties in the markets cannot be overstated.
10 Without the evidence, the economics isn't going to get
11 you all the way there. You are going to need the
12 evidence.
13 I won't go through this in any kind of detail.
14 I just thought through questions on how I might think
15 about doing an innovation analysis.
16 Is innovation an important dimension of
17 rivalry? The answer is no, forget it. Why bother? Look
18 for price effects. Go out with your colleagues for a
19 beer.
20 Second question, will innovation effect
21 existing product markets in a reasonable amount of time?
22 The answer to that is yes, let's not worry about
23 innovation markets. It sounds like a goods market to me.
24 Let's do a competitive effects on the goods market. As
25 Gil will remember, this was the Microsoft/Intuit case.

1 We toyed with bringing a case in an innovation market.
2 We said we have a real market here, why are we bothering?
3 Innovation is an important dimension of competition. If
4 one of the two players is in the market, then we have a
5 potential competition case.
6 I had to sit back for a second and say, I think
7 a potential competition case is easier than an innovation
8 market case? Well, there you have it.
9 Can the boundaries of the innovation market be
10 determined? We went through that. It's not child's
11 play. Does the merger provide incentives us to innovate?
12 Again, I put the efficiencies in with the obligations of
13 the plaintiff. Again, if it's the plaintiff's job to
14 show there is an effect, then the plaintiff should also
15 be comfortable showing the efficiencies don't outweigh
16 the other effects.
17 And then last, the harm to the output market,
18 without this last piece, not only do we have an economic
19 problem, but we clearly have a legal problem as well.
20 With that, I know it's all painstakingly clear.
21 Thank you very much.
22 MR. FRANKENA: Thank you. Ann?
23 MS. MALESTER: Well, I must say that I'm really
24 surprised that this many people showed up this early in
25 the morning to hear us talk about innovation markets, but

1 this must mean all of you are certainly aware that we
2 have been having a debate in the antitrust world for well
3 over a decade about what the antitrust agencies should do
4 about the concept of innovation markets, and essentially,
5 should there be any enforcement actions in this area?
6 As you know, there are those who believe that
7 because the empirical economic data has not been
8 conclusive in showing a correlation between increased
9 concentration and reduced innovation, that really the
10 antitrust agencies should just throw up their hands and
11 walk away and not think about bringing enforcement
12 actions in this area.
13 There are others, and I count myself in this
14 group, who believe that preserving competition at the
15 research and development stages is really important, but
16 recognize, as Steve has pointed out, that there are some
17 real problems and a lot of difficulties in really
18 assessing how innovation markets should be defined and
19 what the antitrust agencies' role really should be there.
20 First, let me just give you two reasons why I
21 think that it's vital for the agencies to preserve
22 competition and be vigilant in protecting competition at
23 the R&D stages.
24 First of all, because in the long run, a merger
25 that reduces the pace of innovation can be far more

1 harmful to consumers than a merger that results in a
2 price increase of quality decrease.
3 Second, because in the real world, where
4 companies compete every day, it's very clear that
5 competition is the primary incentive that spurs increased
6 level of innovation.
7 In preparing for this workshop, I re-read the
8 testimony that the FTC received during the 1995 hearings
9 on global competition. What struck me is that although
10 the economists could only agree that it was really
11 inconclusive and they weren't sure what the evidence
12 showed, the business officials who testified during those
13 hearings were, and I'm quoting the words of the staff's
14 report, "Unanimous and emphatic in their view that
15 competition is the primary incentive for innovation."
16 I spent well over a decade at the FTC as an
17 assistant director in the merger division. I have seen
18 hundreds of documents, and talked to dozens of business
19 officials, who told us that they supported that
20 conclusion.
21 When you look at the reality of the way
22 businesses make their decisions, I think it's clear that
23 typically businesses invest more resources, work harder
24 and work more quickly in their research and development
25 efforts when they are faced with the possibility that

1 they will be beaten to the market by another firm that's
2 working to develop a competing product.
3 We saw evidence in our investigations that
4 companies often spend a great deal of time tracking the
5 research and development projects of other companies that
6 are working in their general area. Companies seek
7 information about the schedule and progress of competing
8 R&D programs, and they make investment and priority
9 decisions based on the level of competition they believe
10 they face.
11 They also confirmed that being the first to
12 introduce a new or improved product can be critically
13 important to many industries. A first mover advantage
14 that gives you increased market acceptance, lock in of
15 customers, there are many reasons why in some industries
16 reaching the market first is very important for future
17 success.
18 Having said all that, I really do agree with
19 Steve when he explained that it is much more difficult
20 for the plaintiffs to predict under what circumstances a
21 merger is likely to reduce the pace of innovation, and we
22 know that it's not that easy to even predict when a
23 merger will result in a price increase.
24 In many cases, it is difficult to identify all
25 the potential sources of innovation, or to identify

1 whether the merged firm will have both the ability and
2 incentive to reduce the pace of innovation after the
3 merger, and finally, even harder to decide what type of
4 efficiencies, if any, the merged company will be able to
5 achieve in combining their R&D programs.
6 I think it's for that reason when you look at
7 the past 10 years in enforcement at both the Justice
8 Department and the FTC, you will see first a relatively
9 small number of cases where the agencies alleged only a
10 reduction in innovation, not tied to an existing current
11 goods market, and second of all, you see those actions
12 that there are generally in the pharmaceutical and
13 defense industries, where first of all, it is quite easy
14 to identify generally the companies that are
15 participating in research and development, and where the
16 barriers to new companies beginning development are
17 extremely high.
18 Let me turn for a moment to the Genzyme
19 investigation, which is the most recent pronouncement by
20 the Commission, and which brought forth three separate
21 statements by the Chairman and Commissioners Thompson and
22 Harbour.
23 That decision could be the subject of an entire
24 panel, so I'm just going to talk about two points.
25 First, really the question about whether in innovation

1 markets, there should ever be a presumption of
2 anti-competitive effects at any level of competition, and
3 second, my own views of what Genzyme might tell us for
4 future Commission enforcement decisions.
5 On the first point, I was frankly puzzled by
6 the seeming importance that all the statements placed on
7 whether or not there should be a presumption of
8 anti-competitive effects. Somehow, that left me with the
9 feeling that in existing goods markets, where
10 presumptions are raised at much lower concentration
11 levels than was the case in Genzyme, but the antitrust
12 agencies bring an enforcement action every time a
13 presumption of legality is raised. We all know that
14 nothing could be further from reality.
15 I think that the data that the Justice
16 Department and the FTC released two weeks ago on
17 horizontal mergers and the concentration levels and which
18 ones resulted in enforcement versus closing, make it very
19 clear that even in existing goods markets, there are
20 highly concentrated markets where merger may reduce the
21 number of competitors from three to two and even two to
22 one, where in some cases, the Commission did not bring an
23 action or the Justice Department did not bring an action.
24 What does the presumption mean? It only means
25 that the merger deserves a really close scrutiny, and

1 that the agency in question will spend as much time as it
2 has to develop an intensive fact based analysis.
3 I don't think there is anyone at the Commission
4 who believes that Genzyme did not deserve that kind of
5 close scrutiny. Both the agency staff and all of the
6 Commissioners spend a great deal of time and effort in
7 analyzing the large investigatory record, and in
8 assessing what the facts were and what the analysis
9 should be, and that is really what I think the
10 presumption means, that it's a case that warrants that
11 kind of scrutiny.
12 Finally, let me just talk for a minute about
13 what the impact of Genzyme is and what it tells us about
14 the Commission and its likely enforcement in the
15 innovation markets.
16 First, I think clearly the Commission's
17 decision indicates that the current Commission is likely
18 to approach any innovation market analysis with a lot of
19 caution, but there are four reasons why I think you
20 shouldn't read too much into what the Commission may do
21 in other cases based on the Genzyme decision.
22 First of all, I think it's important to note
23 that not one of the three statements that were issued was
24 signed onto by anyone other than the author of that
25 statement. Two of the Commissioners, Commissioners

1 Swindle and Leary, although they voted to close the
2 investigation, did not join in any of the statements that
3 were the public statements that were issued.
4 Second, in the Genzyme case, both companies,
5 Genzyme and Novazyme, were actually in the late clinical
6 stages of drug development, which is earlier than the
7 other innovation market cases where the Commission has
8 investigated and taken action before, and that means that
9 the likelihood of both products making it to market is
10 less than in the other cases the Commission has looked at
11 in the pharmaceutical area.
12 Third, the drugs in question were covered by
13 the Orphan Drug Act, which grants a seven year market
14 exclusivity to the first drug that makes it to market. I
15 think that fact also makes it less likely than in a
16 traditional pharmaceutical market that both drugs would
17 in fact compete in a future goods market, and finally,
18 the Genzyme acquisition was not reportable under the
19 Hart-Scott-Rodino Reporting Act, and the transaction had
20 closed well before the Commission was in a position to
21 assess its legality.
22 Trying to design a remedy in an innovation
23 market in a consummated merger where the core assets are
24 scientific personnel, know how, access to academic
25 researchers, and many other human factors, really

1 presents quite a daunting task, and the vast majority of
2 cases that the agencies face, which isn't the typical
3 Hart-Scott-Rodino pre-merger review, I don't think raise
4 the same level of difficulty in designing and
5 implementing a remedy.
6 In sum, I think Genzyme was a very important
7 case because it gave the Commission an opportunity to
8 look at a really complete investigatory record, and to
9 take the time, which often doesn't happen with Hart-
10 Scott, to really debate the issues.
11 Obviously, different people at the agency came
12 to different conclusions on what the facts were and what
13 the conclusions should be. I think it was an important
14 exercise at the Commission.
15 I also think the specifics of that case and of
16 the market in question and the fact that there wasn't a
17 majority opinion on what the appropriate analysis should
18 be, at least should leave everyone with some caution in
19 predicting what the Commission will do in future cases.
20 MR. FRANKENA: Thank you, Ann. Dick?
21 MR. RAPP: I'm in the situation that many FTC
22 speakers are in. I have to issue a disclaimer before I
23 begin, because there are many of my colleagues at NERA
24 that disagree with my extremist positions. Tim Daniel
25 over there, the man with his fingers in his ears, has the

1 look of participatory mortification on his face, is one
2 of those. I want you to know that my point of view is
3 not shared by everybody at my firm.
4 I do find myself once again as the extremist in
5 the group, wishing to repeal entirely the use of
6 innovation market analysis.
7 For those of you who do not know me, I want to
8 assure you that it is not that my position is what it is,
9 not because I'm an anti-interventionist generally, that
10 the good government shouldn't put its aura in, et cetera,
11 that is a poor characterization of my views about almost
12 everything else.
13 I am an opponent of the use of innovation
14 market analysis frankly for an arcane epistemological
15 reason, and that is there is an absence of underlying
16 theory, and in a nutshell, what I mean is that antitrust
17 works well when it is based upon economics. Economics is
18 a science. What that means is that it uses scientific
19 explanation, a hierarchy of general laws and law like
20 statements.
21 The horizontal merger guidelines are a
22 wonderful example of economic science for policy
23 purposes. The SSNIP test and other devices invoke the
24 demand elasticity, which is right in the mainstream of
25 the laws of economic science, going all the way up to the

1 law of demand.

2 Cournot's welfare triangle, Stigler's theory of
3 oligopoly, all underpinnings of the merger guidelines are
4 inherent, and the guidelines have a strong theoretical
5 basis. By the way, we observe consistency with empirical
6 facts as well. That is secondary as far as I'm
7 concerned. I care most about the fact that innovation
8 market analysis is basically reasoning by analogy. The
9 policy premise, as I see it, is the proposition whether
10 the social gain from stopping an R&D merger exceeds the
11 social gain from letting it go through is predictable,
12 that you can tell which way that inequality will run.

13 I think the only basis for that that I can
14 perceive is an analogy to the relationship between
15 competition, quantity and prices in goods markets, and
16 the analogy is false. I won't dwell on that. I wrote an
17 article, as many of you know, in 1995, that captures my
18 views about that subject.

19 Looking now in the five minutes I have, because
20 I will not impinge on the discussion period, where you
21 get to drag out of me in conversation, let me make just
22 three quick points, two of them relating to Genzyme and
23 then an attempt to be a little constructive instead of
24 being a naysayer. Steven here is sick of having to
25 accuse me of bothering an ugly baby. Let me see if I

1 can't do something better than that. Whose baby is that?
2 I want to point out -- I'm going to go through
3 this whole slide -- it's really the first point that I
4 wish to remark to you about, and that is that I am an
5 admirer of Chairman Muris' statement in Genzyme. It is
6 remarkable to me for the fact that it changes the basic
7 policy rule. It has to do, as Ann described very well,
8 with peculiar circumstances of the case, but one should
9 not lose sight of the pun on the word "competition."
10 What we are talking about now is a race to
11 monopoly. It has nothing to do with the kind of
12 competition that is output expanding, price reducing
13 competition, the likes of which we talk about when we
14 talk about horizontal mergers. Market power has nothing
15 to do with this.
16 The underlying characteristic of -- let me say
17 the most basic finding in the majority statement is even
18 though they are nowhere near the end of the race, that
19 the pace of the two parties is predictable, the issue is
20 not who is going to come in first. It's whether or not
21 the second will come in at all or come in sooner rather
22 than later.
23 The fact that there is no possibility for delay
24 of the first one getting to the deadline as a result of
25 the merger means the merger has no negative impact.

1 That's my quick two second reading of the majority
2 viewpoint without all of the reasoning that follows.
3 All I wish to say is that as an analysis of
4 incentives, it makes a great deal of sense to me. It's
5 quite novel. That doesn't bother me as an economist.
6 The lawyers in the group can consider how it would play
7 at Section 7 or FTC Section 5 enforcement, but I think
8 it's unusual.
9 My real focus is on Commissioner Thompson's
10 dissent, because I have to say in the debate between the
11 extremists and those who favor the innovation market
12 approach, as far as I'm concerned, I can't be both a
13 player and a referee, but I have to say as far as I'm
14 concerned, my reading of Commission Thompson's dissent
15 led me to say game over, I win.
16 This is a litany of what can go wrong if merger
17 analysis is applied using its very premise, that is to
18 say reason by analogy to the goods market.
19 You talk about a merger, a monopoly, and speak
20 about market power, even though there are no goods around
21 and market power is not the issue.
22 I know about presumption of anti-competitive
23 effect without either theoretical or empirical basis.
24 There is this -- now we are getting back to the lesser
25 things that I won't dwell on so we can get to the

1 conversation part -- this struck me as extraordinary.
2 There is a difference to be expected in the
3 resource allocation of Genzyme, arising from the
4 difference between trying to get the first approval with
5 orphan drug exclusivity, to save a lot of children's
6 lives and make a ton of money, and trying to get first
7 approval with orphan drug exclusivity for a longer period
8 of time for the sake of first mover advantage.
9 I can go along with all of those who say
10 competition spurs innovation. It makes a certain amount
11 of sense. You see how the notion can be, I would say,
12 misused. It represents to me a believer in competition,
13 certainly an oddly crabbed view of human nature.
14 There is a further litany of errors, errors in
15 economics and logic, but I believe here, in Commissioner
16 Thompson's dissent, we can talk about them if you like,
17 my worry is that some day President Kerry might appoint a
18 Commission with this frame of mind, and that is the
19 reason why a line of by and large sensible -- I won't say
20 unobjectionable -- to me, understandable decisions both
21 by the Pitofsky Commission and the Muris Commission, are
22 not good evidence that we are okay with the innovation
23 market concept.
24 Let me see if I can do what Chairman Pitofsky
25 did to me at the 1996 hearings, to try and find some

1 compromise in my extremist position.
2 At the very end of that panel, he put the
3 following question to me. He said, look, just imagine
4 that Boeing is building the next airframe. There are two
5 jet engine makers. They are about to sit down with their
6 cam systems and start designing the new jet engine that
7 would go along with that.
8 Do you propose that the Federal Trade
9 Commission, if they came to us and said we want to merge,
10 we want to do a joint venture, we want to turn those two
11 research efforts into one, that we ought to just go away?
12 My answer to him was no, sir. What I wish I
13 had said is no, sir, and here is why. No, sir, because
14 you can do a goods market analysis, even though the first
15 good, the design and character of either good has not
16 been invented. You have the means to analyze not
17 research effort and whether or not they will pour it on
18 to a greater degree on R&D spending or effort, if they
19 merge, because you can't predict that.
20 What you can do is you can say, look, this is a
21 case where there are going to be two goods competing with
22 one another versus one, if the merger or the joint
23 venture takes place. We can use horizontal merger
24 guidelines reasoning to deal with that, and that makes it
25 okay with me.

1 My attempt at a constructive end to my
2 extremist talk here is to say that to the extent that we
3 are -- let me put it in terms that Mark used when he
4 wrote us a series of possible questions to discuss.
5 I think the distinction between innovation
6 markets that pay attention to R&D effort, about which we
7 know very little and predict very little, the distinction
8 between that and future goods markets, which to me means
9 taking only those cases where we can actually foresee
10 what the goods are and what the number of players, the
11 number of pricing voices will be, and make some attempt
12 at doing horizontal merger guidelines analysis.
13 That distinction between innovation markets on
14 the one hand and future goods markets is very great, and
15 as far as I'm concerned, one that should strive and be
16 well, and the other should quietly go away.
17 Thank you.
18 MR. FRANKENA: Thank you. Just following up on
19 that, I'd like to ask Ann a question. Let's assume back
20 in 1995, the antitrust agencies had completely listened
21 to what Dick said, and had said that henceforth, in going
22 forward, we won't be defining innovation markets. We
23 think innovation is important and we think competition
24 may affect the rate of innovation, but we're not going to
25 delineate innovation markets, so we don't want our staff

1 to be doing that.

2 My question for Ann is what difference would

3 that have made in the types of investigations, things

4 like that?

5 MS. MALESTER: I think there are maybe two

6 examples that I can use to show you why I think Dick's

7 approach presents enormous dangers to competition, that

8 would allow mergers to proceed, that I think would have

9 really, really serious anti-competitive impact.

10 The first might be similar to the case that the

11 Justice Department brought, and I think it was during the

12 time Steve was there, Lockheed/Northrop Grumman.

13 It was really a step further back from the

14 Boeing example that Dick and Chairman Pitofsky talked

15 about, where the Justice Department raised the concern

16 that there were only three companies left in this country

17 that really had the capabilities of designing military

18 aircraft, and if Lockheed were permitted to buy Northrop

19 Grumman, that would be reduced to two.

20 There were no specific plans for a fighter

21 aircraft, but as we all know, in military procurements,

22 there are eventualities that arise that very quickly turn

23 the Defense Department into needing something new to meet

24 a new military challenge.

25 Even though there wasn't a future goods, a

1 specific program or product on the drawing board, both
2 the Justice Department and the Defense Department felt
3 very strongly that one of the reasons to block that
4 merger was to preserve the capabilities of designing and
5 producing a particular weapons platform.
6 I think that is a step sort of removed from
7 Dick's position of we have to have a specific good that
8 we are looking at, even if the first one hasn't been
9 produced yet. I think it's a case that if allowed to
10 proceed would have very serious anti-competitive effects
11 for our economy, and in that case, for our national
12 security.
13 The second point I want to make is moving even
14 further back away from the future goods markets, and this
15 may be something that is specific to the pharmaceutical
16 industry, and that's an industry that I did a lot of work
17 in, but may be applicable to others. I'm not sure.
18 That is apart from looking at what the impact
19 of eliminating the merger is on the future goods market,
20 is it going to mean that there will only be one company
21 selling a product at some point.
22 There is actual competition going on during the
23 research and development phase when two companies know
24 that they are both trying to develop the drug, and want
25 to get approval first. Those companies will, for

1 example, do clinical trials that involve many more
2 patients, to make sure they get a broader range of
3 patients with different kinds of seriousness of disease.
4 The kinds of clinical trials they do, the
5 amount of effort and outreach to patients they do, there
6 are benefits right now in the present of having two
7 companies competing to develop a drug, completely
8 separate from the actual benefits, potential benefits,
9 that we are not sure will be realized because we don't
10 know yet if both companies will successfully develop the
11 drug.
12 I think that may not be completely responsive
13 to your question, Mark, but I think that gives an idea of
14 the different kind of scenarios that gives me concern, if
15 we take Dick's position to say absent a very identifiable
16 good that companies are actually producing or are about
17 to produce, the agency should simply step away.
18 MR. SUNSHINE: Let me just jump in here, too.
19 I was actually tremendously comforted by Dick's last
20 example, but if we go back to the engine example, and
21 engines take years and years to develop, but if it's that
22 situation where Dick sees a potential enforcement action,
23 what we are talking about is the area of competitive
24 interaction between the two companies is in research and
25 development.

1 Yes. There will be a goods market, but that
2 goods market is a long way off. Usually outside of what
3 we normally consider to be within the reach of Section 7
4 of the Clayton Act.
5 Innovation market is an immediate step to
6 identify where the activity of the two companies come
7 together and where there might be an actual reduction.
8 In the case that Dick put forward, there will
9 be less innovation competition in developing this new
10 engine some years off, which will translate itself into
11 output.
12 If you want to say, no, no, that's not an
13 innovation market, that's a future goods market, fine.
14 Now we are talking semantics.
15 MR. RAPP: Are we talking semantics then if we
16 rule out the application of the innovation market concept
17 to the Genzyme case? There, there is no prediction that
18 we could make about how many goods would otherwise go to
19 market, what the future market would look like. There
20 are no such goods.
21 I see that as a sharp distinction. In other
22 words, my primary criteria is that the analysis not deal
23 with issues like the degree to which R&D spending will be
24 cut back or reduced. It has to do with an analysis of
25 some future, some prediction about a future goods market.

1 That's the distinction I want to draw.
2 MR. SUNSHINE: How do you get there? How do
3 you get to the output effect on the goods market without
4 understanding what's going on at the research level?
5 MR. RAPP: It maybe that what I'm talking about
6 comes very, very close to the concept of potential
7 competition, where we are already very close to home.
8 You can do that even if the design of the goods
9 hasn't occurred, if you can predict the future. This is
10 a closed conversation.
11 MR. SUNSHINE: But just on the potential
12 competition, you would then relax the two year time
13 frame.
14 MR. RAPP: Sure. It means nothing to me.
15 MR. SUNSHINE: Now, I think we are just in
16 different legal labels for looking for the same effect.
17 MR. FRANKENA: All right. You will need to get
18 a microphone.
19 MR. DANIEL: I'm Tim Daniel, the aforementioned
20 NERA colleague of Dick.
21 I would be curious -- I liked the jet engine
22 example a lot. Suppose one flows into that going into
23 the production process that Boeing and everyone else
24 knows that there is some probability that this engine
25 simply will not be a success, that the project they have

1 on the table is for an airplane that requires advances in
2 science and advances in material science or something
3 where there is some probability that engine won't work.
4 So, you don't know with certainty there will be such an
5 airplane in need of such an engine.
6 I would be curious if the panelists generally
7 could just speak to how that analysis might change if
8 that were thrown in.
9 MR. SUNSHINE: I think it's an essential part
10 of the analysis. Again, the idea has got to be a focus
11 on what exactly are the incentives of the parties, and
12 what effect is the combination going to have, factors in
13 terms of are there efficiencies that come from it, the
14 necessary investments, because of the size of the project
15 and the risk of the project, whether it requires one firm
16 instead of two.
17 All those considerations go into the question
18 of whether this makes sense or not. For all the reasons
19 we have talked about before, applying straight horizontal
20 merger guideline standards to this innovation question is
21 misplaced.
22 If this project is so risky that two firms need
23 to do it together or it won't get done, I think that
24 answers the question.
25 Let me stop there. I'm sure Dick doesn't feel

1 differently about it. I don't know, Ann, if you have a
2 different view.
3 MS. MALESTER: It seems to me it is not only
4 the question of is the standard that Dick puts forward
5 requiring that we know that a particular product be
6 successful, that they will in fact design an engine,
7 which I think really is a pretty extreme position, but I
8 would take the added step of saying if there are only a
9 very small number, in this case, two companies, that have
10 the technology and know how and expertise to design
11 aircraft engines, then we should be concerned about
12 allowing that merger for future aircraft engine
13 developments that aren't even yet on the drawing board,
14 and that was really why I brought up Lockheed/Northrop.
15 Stealth technology. That was another reason
16 why the Defense Department and Justice Department felt it
17 was critical to keep a number of companies that knew how
18 to --
19 MR. RAPP: The quick mental analysis that you
20 did to reach that conclusion doesn't really have much to
21 do with an analysis of what is going to happen to R&D
22 efforts. It has to do with being able to forecast, even
23 if it is decades down the road, how many goods are going
24 to be available at the end. I'm okay with that because
25 it's processible in economics, as opposed to assertions

1 about whether more R&D or less R&D effort will arise and
2 whether that's a better or a weaker thing. This slides
3 somewhere in there, but I won't bother illustrating it.
4 A decade or so ago, we had 27 drug companies,
5 big drug companies. These days, we have seven of them.
6 Is anybody prepared to say that major losses to R&D
7 effort have arisen because of the combination of those?
8 I don't think we are in a position to say that the
9 connection between concentration and innovation --
10 MS. MALESTER: I think that's a very, very
11 different proposition than what we have really been
12 talking about, which is competition or the lack of
13 competition, not whether or not there are 27 or 10, I
14 don't think in any current goods market that would
15 concern us.
16 I do think -- I don't think anyone on this
17 panel has said that we can look at the dollars spent on
18 R&D and say it's more or it's less and that means we are
19 going to get a better product, we are not.
20 Those are really not the issues on the table.
21 The question is whether having competition in designing a
22 new weapons system, for example, is going to provide the
23 purchaser with a better product in the end, a more
24 innovative, a more radical breakthrough.
25 I think there are quite a number of historical

1 assessments you can look at that say yes, they do.
2 MR. HOVEN: I'm John Hoven, Justice Department.
3 I'd like to make the point that each of you
4 were just talking about tools in the shed, and there are
5 many others, and yours are relevant for some purposes and
6 not for others. I think the Lockheed/Northrop merger is
7 a good illustration of that.
8 The presumption of the innovation markets
9 analysis is that innovation is a very predictable
10 process, just like building bricks. You spend the R&D
11 and you get a product.
12 A good example is the expectation that the kind
13 of innovation we are looking at is innovation that has a
14 known identifiable product at the end. I think to some
15 extent, that was true, and to some extent, that was not
16 at all true in Lockheed/Northrop, that innovation in many
17 industries is a process of ideas coming together in
18 unexpected ways and you want to preserve an industry
19 structure that allows that to continue to happen, and in
20 particular, in some cases, an innovation structure that
21 generates ideas, products that nobody can think of yet.
22 I think the general process of innovation
23 analysis ought to be one in which one inquires how does
24 innovation take place in this particular industry, and
25 maybe it's the kind of approaches you are discussing, but

1 there are a lot of others that should be examined as
2 well.
3 MR. SUNSHINE: I think certainly in the
4 framework that I put forth, and I think in the framework
5 that actually Muris puts forward in the statements, is
6 the recognition of what you said is exactly right.
7 The question is should we examine the
8 innovation market and under what circumstances can we
9 actually accomplish innovation effects. It's a small
10 minority of cases. If you can't have the confidence to
11 predict it, then you should go home.
12 Once you say that, then if you're talking about
13 innovative activity, there are three categories of what
14 can happen. It can be innovations that will be used in
15 the future product. It can be innovations that are used
16 in existing product, or it can be innovations that won't
17 be used at all.
18 That last category I don't think antitrust
19 enforcement should care about. For the first two
20 categories, now we are talking about legal theories, is
21 it a competitive effect of a goods market, is it a
22 potential competition case. I don't care what the answer
23 to that is. When you get into a court, you are going to
24 have to have developed your legal theory and put it
25 forward.

1 To me, that's the connection. Find the
2 innovative effect, put it with confidence under the given
3 set of facts, if you can. If you can't, you shouldn't be
4 in the business. Identify an output effect, and then
5 there's a case.
6 MR. RAPP: May I just add a sentence with that
7 in mind? It is perfectly consistent with the majority
8 statement in Genzyme, but I think, and this is the
9 troubling part from my standpoint, that it is also
10 consistent with the dissent, in that Commission Thompson
11 may have used the same reasoning and had sufficient
12 confidence in his ability and that of his advisors and
13 staff to see through these issues. I think it's an
14 example of what can happen when innovation market
15 analysis goes wrong.
16 MR. SUNSHINE: I agree with your criticism of
17 Commission Thompson's dissent, and I think it is wrong.
18 I think in that dissent, he does make a straight analogy
19 to a goods market, for the reasons we have talked about,
20 that is improper. If that were the policy of the
21 Commission, I think it would be misguided. That's not
22 what Chairman Muris says.
23 MR. FRANKENA: I have a question for Dick.
24 Based on Chairman Muris' statement, and if you just
25 accept the facts, are you comfortable with that word of

1 "analysis," of trying to reason out the effects on
2 incentives and so forth?
3 MR. RAPP: Yes. I'm comfortable with
4 "analysis" as long as it reaches the conclusion that is
5 functionally the equivalent of not making innovation
6 market policy.
7 One of the reasons that I admire what the
8 Chairman's statement does is that it reasons sensibly by
9 analyzing the incentives to an outcome that says let's
10 leave this alone, and what I find hard to imagine, and
11 maybe it's the shortage of imagination on my part, I have
12 a great deal of respect for our former chairman who would
13 advocate this policy, of Steven and Rich Gilbert, who are
14 the parents, but I cannot imagine a well reasoned
15 economic statement -- a statement that is well reasoned
16 in economics that says and now let's intervene.
17 MR. FRANKENA: Taking a broader view here, one
18 of our panelists wrote in the mid-1990s antitrust laws
19 and merger enforcement in particular have not focused
20 sufficiently on the consequences of market power for the
21 pace of industrial innovation.
22 I'm just wondering broadly whether you think
23 the agencies are doing sort of the right amount, too
24 much, and so forth.
25 MR. SUNSHINE: Those words sound strikingly

1 familiar. I don't know where they came from.
2 Again, those words were written in 1994 and
3 1995. I think that during the time period after that,
4 there has been a whole set of investigations by both
5 agencies where there has been real focus on innovation.
6 There are cases where I would certainly agree
7 with Dick that innovation analysis may have been carried
8 to the extreme or inappropriately applied or applied
9 without basis. I would not take the position today that
10 innovation is under enforced, but as I said today and I'm
11 glad we stuck with the analogy of tools in the shed, it
12 is a tool in the shed. It is not the sharpest tool in
13 the shed. It's one that should be used only in the right
14 circumstances. I don't feel it's under used today for
15 sure.
16 MR. RAPP: I'm going to not answer the question
17 directly but raise an issue that arose out of the global
18 marketplace report, the 1996 report, and it was
19 specifically quoted in Chairman Muris' statement, which
20 puzzles me enormously, and I wonder whether I am the only
21 one.
22 That is this business of saying we recognize
23 the potential infirmities with this approach, so we are
24 going to be very cautious and conservative and apply it
25 in circumstances where only small number mergers are

1 involved.

2 Is that a fair statement, Ann?

3 MS. MALESTER: Do you mean small number of

4 competitors?

5 MR. RAPP: Small number of competitors. To me,

6 that is not conservative. That's radical. Am I the only

7 one that thinks that? It's conservative in the sense of

8 avoiding waste, in that if you don't carry innovation

9 market analysis into every seven into six merger, you are

10 receiving resources in some sense, but in those settings,

11 in the large number settings, you are going to have --

12 the likelihood is that the merger is going to be allowed

13 because somebody else is going to win, and if there's a

14 false positive that arises in your innovation market

15 analysis, in your merged number setting, it's not going

16 to be that consequential because somebody else is going

17 to get to the finish line.

18 My definition of non-conservative radical

19 enforcement is to take this controversial concept to look

20 only to those mergers where it will be consequential

21 because you are intervening in a merger that is going to

22 determine the output of innovation, if you will, and

23 where if you get it wrong, there has to be harm as a

24 result. It's a semantics issue on the one hand, what you

25 do mean by "conservative," but we shouldn't lose sight of

1 the fact that we are only doing it into two to one
2 mergers, so it must be benign. At least in my view, the
3 opposite is true.
4 MS. MALESTER: I think really the reading of
5 what that global report meant and what the Chairman, I
6 think, alluded to, is simply the consensus that an
7 unilateral theory is by far the most likely if we are
8 going to apply an innovation market at all, and generally
9 speaking, you are looking at a very small number of
10 companies that have the specialized assets, so to speak,
11 to be innovating in the market before you are even
12 starting to think about unilateral theories. That really
13 was the impact of that.
14 MR. RAPP: I don't disagree.
15 MS. MALESTER: In terms of your point of yes,
16 it's radical because where it makes a difference, we will
17 just turn it around and say it makes a difference, and
18 from my point of view, because I think protecting
19 competition where it makes a difference is important, I
20 think it is the right place to put our efforts.
21 MR. RAPP: If that statement were always
22 prefaced by the prior statement, that the reason to be
23 conservative is that we are dealing in a realm of
24 uncertainty when we can't be all that confident that the
25 decisions that we make will be the correct ones, if it

1 weren't for that, I could go along easily. The
2 combination of those two things together strikes me as
3 problematic, my only point.
4 MR. SUNSHINE: Let me ask you one question tied
5 to Genzyme. Suppose that the drug in question did not
6 qualify for orphan drug status. Does that change the
7 outcome of the case? Orphan drug status, for those of
8 you who are not pharmaceutical, it's not a winner take
9 all situation.
10 MS. MALESTER: I think there are a lot of facts
11 that go into coming to a decision. In my own view, the
12 orphan drug situation adds a complication, but in and of
13 itself, shouldn't bar there being a case altogether, and
14 it's one factor you look at in a very large number of
15 factors in assessing whether or not the Commission should
16 take action.
17 MR. FRANKENA: Just one final question. Is
18 there anything that you think the antitrust agencies
19 could or should try to clarify about their approach to
20 analyzing the effect of mergers on innovation? Is there
21 anything left they could actually do?
22 MR. RAPP: I think conversations like this are
23 illuminating. I can't think of anything other than that.
24 You know, seeing Greg Werden and Luke over there sitting
25 side by side leads me to ask a question. If it's not

1 fair, forgive me.
2 Are there or have there been interactions
3 between the agencies about the differences in the
4 application of it? I won't ask for specifics. That's
5 the comparison. Obviously, the FTC, with its focus on
6 drugs gets a lot more cases where entry barriers are high
7 and things like that. I'm curious to know about whether
8 or not there is interaction between the agencies on
9 enforcement of innovation markets.
10 MR. FROEB: Not on specific cases, but
11 certainly on general policy matters, I'd say yes.
12 MR. WERDEN: None that I participated in.
13 MR. SUNSHINE: I thought Greg and Luke were
14 working on the 2004 innovation market merger guidelines.
15 MR. FRANKENA: Thank you very much. I'd like
16 to thank both our panelists and the audience.
17 (Applause.)
18 **UNILATERAL EFFECTS**
19 MR. FROEB: Welcome to the session on
20 unilateral effects analysis. We have five speakers
21 today.
22 We have Greg Leonard. He's here. I know he's
23 here. We will start with Valerie Rabassa from the
24 European Commission, followed by Joe Kattan, Greg Werden,
25 and Tad Lipsky, and then Greg Leonard, if he gets here in

1 time. He will bring up the rear. There he is.
2 I want to thank the panelists for agreeing to
3 come on relatively short notice. I also want to thank
4 the staff who has put together this conference, and also
5 worked on the enforcement data, getting the enforcement
6 data together, and releasing that as part of our desire
7 to be more transparent to the external bar and the
8 external community.
9 I also want to acknowledge the efforts of my
10 predecessor, Dave Scheffman, who began much of the work
11 that is now just coming to fruition.
12 By 1999, they had displaced the structure
13 conduct/performance paradigm in industrial organization
14 economics, thinking on pricing and output coordination in
15 oligopolies had evolved considerably from the view that
16 it made coordination almost inevitable.
17 While economists never entirely rejected
18 coordinated effects theories for mergers, they did reject
19 exclusive reliance on them, and they had more plausible
20 theories for many cases. Thus, it was not surprising
21 that unilateral effects analysis appeared prominently in
22 the 1992 horizontal merger guidelines, which were jointly
23 promulgated by the FTC and the Department of Justice.
24 The unilateral effects analysis satisfied the
25 attorneys' demand for simple intuition that they could

1 understand and explain to a judge, and at the same time,
2 it satisfied the economists' demand for more rigorous
3 analysis. It wasn't long before economists began using
4 structural theoretic models to make quantitative
5 predictions of unilateral competitive effects.
6 In a price setting model, price goes up. In an
7 option model, firms don't have to bid as aggressively to
8 win. In a bargaining model, the merged firm gains
9 bargaining power. In the equality setting model, well,
10 we learned that mergers aren't usually profitable with
11 equality setting models.
12 The controversy surrounding unilateral effects
13 analysis has focused on the application of structural
14 models to individuals cases, their main virtue is they
15 force assumptions to be made explicit and they provide a
16 clear mapping for the facts of the case to the effects of
17 the merger.
18 The shortcoming is that the models are
19 necessarily unrealistic and abstract away from the
20 important features of the industry. As such, the results
21 may be quite misleading.
22 Unfortunately, we have little evidence on
23 whether these models can accurately predict the effects
24 of real mergers. Instead, we are left with controversy
25 about what is the best way to analyze unilateral effects

1 theories.

2 What follows is we will hear from Valerie
3 Rabassa, Joseph Kattan, Greg Werden, Tad Lipsky, and Greg
4 Leonard on this and more general topics. Let's start off
5 with Valerie.

6 MS. RABASSA: Thank you, Mr. Chairman.

7 Let me talk about the Lagardere case. It's a
8 European case which took place last year in France. It
9 was analyzed by the European Commission. It is one of
10 the leading 2003 cases of the media industry.

11 Let me talk about the transaction. It was very
12 simple. The transaction concerned a transaction between
13 the first and second player of the book industry. The
14 book industry in Europe is characterized by a very high
15 level of vertical integration. Different animals in this
16 industry. In the upstream market, you have the
17 publishing right, and who sell the rights to the
18 publisher, and distribute the books to the retailers who
19 distribute or sell the books to the final consumer. And
20 given the particularity of these cases was an econometric
21 study carried out for the Commission by Professor Marc
22 Ivaldi, and it studied basically the effects of trash and
23 trees in the downstream segment.

24 It was very interesting because it was the
25 first time that we incorporated an econometric study into

1 a final decision. In this study, they will in effect
2 measure, as you know, the entire concentration, the fix
3 in price, and then we have the impact to the final
4 consumers who produce and choose a profit of the firm.
5 So this was the launch with VUP, if Lagardere
6 had decided to increase price obviously unilaterally,
7 some of the final consumers would turn to the other
8 competing publisher, who may reach VUP. So I've always
9 thought of the concentration with VUP has shared a
10 subsidiary of Lagardere to accept part of this
11 competitive pressure, and so can recover part of these
12 customer.
13 In this case, we use a very strong model, the
14 nested logic model, which is quite adapted to the book
15 industry, which is characterized by differentiated
16 products. The logic model, as you know, is from the
17 family of the discrete choice model, which was very
18 interesting in this case because obviously you cannot buy
19 too seminal a book.
20 The consumer in this case made a discrete
21 choice, a model, a different set of economists and then
22 choose a book on the concerned list. Simulation is
23 consistent with the Bertrand Model of competition and the
24 estimation was three stage least-squared.
25 So the reasons why it's quite interesting is

1 because we find that the end price of the books were
2 significantly increased in the downstream segment.
3 Obviously, we were looking at the consumer surplus and we
4 find that consumer surplus will also fall significantly,
5 which was equivalent to a very negligible part of the
6 turn-over of industry in the field I'm generally tied to.
7 What was wrong obviously there is that the
8 price increase was linked with the market size, and we
9 were able to reconstitute the market size in this case.
10 Again, we decided to receive -- the results
11 were quite robust to incorporate it into the final
12 decision, and we have used a boot strap method to
13 construct confidence intervals that are quite often used
14 in the econometrics field and we find that there is only
15 five percent variability that the price rise to the
16 concentration that could be including significant a
17 significant interval of plus or minus one percent, with
18 the mean value of the price change.
19 Results were quite robust because of the very
20 high number of observation to at least 10,000. The
21 different statistical traits were quite significant, and
22 the main parameters, I mean the marginal ATAF of a given
23 book and the intra-brand correlation were quite stable.
24 Altogether I feel that's reasonable to quite robust as
25 for when we decide to incorporate this econometric study

1 into the final decision.
2 Thank you very much.
3 MR. FROEB: Joe, you're next.
4 MR. KATTAN: I want to talk about, I think,
5 differences between the ways that lawyers tend to look at
6 unilateral effects and the way economists do, and
7 particularly with reference to the new models, the merger
8 simulations that are being done increasingly in
9 unilateral effects cases.
10 I want to begin by just talking a little bit
11 about the 1992 guidelines and what they say, and to
12 contrast that a little bit with the new simulation models
13 and pose the question whether we are asking the same
14 questions, that is do the guidelines give guidance or do
15 these simulation models answer the same questions that
16 the guidelines are asking.
17 I think it's pretty clear that the 1992
18 guidelines really changed the way that people look at
19 unilateral effects before 1992. Unilateral effects were
20 basically thought of in terms of monopoly or dominance,
21 and the insight of the guidelines was that unilateral
22 effects can arise outside the monopoly context.
23 The merger of Daimler and Chrysler does not
24 exactly have the same effect as the merger of Daimler and
25 BMW, and if you were just looking at HHIs and market

1 shares, you may get a misleading answer.
2 Some people thought we were returning to
3 submarkets, which was a term that had been discredited at
4 least within the Beltway. Certainly, if I were
5 litigating a case on behalf of the agencies, I would rely
6 on the submarket nomenclature simply because it is
7 something that the courts are familiar with and are
8 comfortable with, regardless of whether that nomenclature
9 really makes a lot of sense in terms of the way we do the
10 unilateral effects analysis.
11 I think it is certainly the case that inclusion
12 of unilateral effects was the most important change in
13 merger law since the 1982 guidelines, and had a very
14 profound effect on merger enforcement, and it wasn't that
15 very long ago that one could hear people talking about
16 whether unilateral effects was in fact the only valid
17 theory for looking at mergers. I think the pendulum has
18 swung back a little bit.
19 I think it's fair to say that what we saw in
20 the guidelines is a synthesis of good economic theory,
21 but also practical judgment about the qualities of the
22 tools we have available to us in merger investigations,
23 and how refined a judgment we can make about the effects.
24 To repeat very briefly what the guidelines say,
25 not to state the obvious, but to give a benchmark for

1 what we are looking at, the guidelines focus on spacial
2 separation between products and product space. The focus
3 is on localized competition where certain sellers compete
4 more closely with one another than with other sellers who
5 are in the same product market.
6 According to the guidelines, that requires that
7 there be a significant set of shares of consumers who
8 regard the product of the merging parties as their first
9 and second choices, and certainly the way that lawyers go
10 about applying the guidelines is by asking very often
11 about whether we are dealing with first and second
12 choices. That's one of the first screens one applies
13 when trying to look at a case for the first time.
14 We have a 35 percent screen for the merged
15 entities' market share, the debate whether that is a safe
16 harbor or something else, but in fact, we have seen cases
17 where the market shares were lower than that that have
18 been brought.
19 I think these reflect a pragmatic tradeoff
20 between quality of the analytical tools that are
21 available in merger investigations and the theory. It is
22 certainly possible to argue, in fact, it has been argued
23 by Greg Werden and others, that you can have an
24 anti-competitive effect in a merger where the merging
25 parties are not the first and second choices of

1 customers, and you can certainly draw the theoretical
2 picture that would be supported and have numbers to
3 support it.
4 The question certainly in 1992, and not
5 accounting for all developments and the analytical tools
6 that have taken place since then, was what are the tools
7 that we have and how refined a judgment can we make, and
8 the judgment was, at least at that point, we are going to
9 look at next best substitutes.
10 Now, the way that the lawyers tend to approach
11 the issue of unilateral effects is, I think, familiar to
12 most people here. You look at markets, first of all.
13 You define a market, and you do that because not only the
14 guidelines say that, but Section 7 case law says that.
15 More broadly, I think doing an antitrust case
16 without defining what the market is is a recipe for
17 disaster.
18 There was a recent case involving Rambus
19 Company that is in the news, where Infinion brought both
20 antitrust and fraud claims against Rambus. The antitrust
21 claims were thrown out because Infinion forgot to define
22 a geographic market for memory chip technology, something
23 that probably would have taken two paragraphs in the
24 expert reports.
25 I think economists often take the position that

1 defining markets is superfluous if they can get to the
2 answer more directly, and that may or may not be right,
3 but certainly from the viewpoint of the courts, if you
4 don't define the market, you may find yourself out in the
5 street, given a case like Infinion vs. Rambus, where the
6 definition of the geographic market was clearly a red
7 herring.
8 Once you define the market, I think the lawyers
9 focus on the issue of next best substitutes. Why?
10 Because that's what the guidelines say, and the analysis
11 is driven by interviews and documents. A lawyer's fetish
12 is to ask for way too many documents so that you can have
13 boxes and boxes of documents stacked up in the hallways.
14 I think there is a critique that one hears from
15 the economists that lawyers use models but don't
16 articulate them with sufficient particularity.
17 Certainly, the legal method does not require articulation
18 of the model the way the economic method does, and when
19 you look at the economic model, it tells you what the
20 assumptions are and if assumptions are not made, what
21 the limitations are. Lawyers don't tell you exactly what
22 the models are.
23 The model effectively if we look for
24 significant market share. We look for next best
25 substitutes, and that embodies certain assumptions on the

1 effects of the internalization of loss sales. That is
2 sales that would have been lost to the merger partner
3 that now is internalized as a result of the merger, the
4 effects of that on the merged firm's incentives.
5 It's certainly true that the economic models
6 spell out their assumptions with greater particularity.
7 Lawyers have an advantage. The decision makers and the
8 courts are lawyers. You cannot have a legal argument
9 thrown out on Daubert grounds, you know, the economic
10 models, which may be equally valid, are subjected to a
11 different kind of scrutiny, at least once you get it to
12 the court. It's a different issue at the agency.
13 The economists, I think it is fair to say, are
14 less bound by the guidelines because the methodology of
15 looking at what the rules are and applying them, that is
16 a legal methodology, and in fact, I've heard countless
17 times from various economists in various contexts,
18 mergers and otherwise, that the whole process of defining
19 markets and driving the analysis that way is an
20 artificiality, and if we have the tools that allows us to
21 get to the answer more directly, you know, why bother.
22 There is certainly an institutional bias
23 against the approach that the lawyers use. I think the
24 economists have a desire to try to get closer to "the
25 real answer." The tools that the lawyers use are fairly

1 crude in many cases, making predictions about the future,
2 relying on assumptions, some of which are stated, some of
3 which are unstated, and have various degrees of support,
4 and obviously, if through the application of the data
5 methods, data analysis, you can get closer to the real
6 answer, why not try to do that.
7 It is certainly the case that the economic
8 approach has the advantage that the models have well
9 articulated specifications, which the legal approach does
10 not.
11 One of the things that we see now is that
12 economists have an insatiable appetite for data. The
13 lawyers want documents. Economists want data. There is
14 a belief that virtually everything can be solved through
15 data exercises.
16 We have these models, and we can talk about --
17 Tim made the comment to the effect that the analysis not
18 helped by relying on the jargon, but I think there are
19 questions about whether the constraints of Bertrand
20 models are realistic in the context of differentiated
21 markets because they allow one point for differentiation,
22 which is price, and in fact, at least the way the issue
23 is posed in the guidelines, we are looking at a host of
24 variables that affect the positioning of different
25 competitors in product space.

1 The insinuations are with us, and I think they
2 are going to be with us for a long time, whether or not
3 the lawyers like it, we are going to have to deal with
4 it.
5 Modeling simulations can be mutual if we are
6 all comfortable that they are attuned to the market
7 realities, that they are based on defensible assumptions,
8 and that's obviously where the debate has been.
9 One criticism has been that a small difference
10 in the assumptions can make very big differences in the
11 results. The answer that I think you will hear from the
12 economists is well, we have different ways of doing
13 things, we should probably do it more than one way and
14 impose some kind of reality check on your analysis and
15 also try to use the method that's the most conservative
16 from the standpoint of the party that you are.
17 I'll pose the question whether there is a
18 conservative assumption from the standpoint of the
19 plaintiff, as all these models seem to be designed to
20 show a price increase.
21 Part of the issue that I have is price
22 increases are assumed in these models based on structural
23 assumptions, even though we are trying to run away from
24 structural analysis.
25 The question is what are we trying to show

1 here? Are we trying to show what the magnitude of the
2 price increase is. I think everybody will tell you no,
3 that's not what we are trying to show, but I think that's
4 where it comes out.
5 When you get somebody telling you that I can
6 predict with 95 percent degree of confidence that you
7 have a price increase of 7.4 percent, you know, some if
8 it even has a decimal point, it sounds so precise that
9 you can debate that. Of course, there's a footnote that
10 says, well, if you accept all my assumptions and that's
11 also before I take into account issues like repositioning
12 of product entry and efficiencies.
13 There is a risk, I think, of false empiricism
14 where you have these results which are so precisely given
15 with high degrees of confidence and decimal points, you
16 know, somebody is telling you this is the price increase
17 they are going to get.
18 I think this is fairly paradoxical, but the
19 economists' approach is more likely to identify problems
20 with a merger than the more traditional way the lawyers
21 do, simply because the models are designed to predict a
22 price increase, and because these models will predict a
23 price increase, even in relatively unconcentrated
24 markets, I think they tell us something, which is either
25 the models have a problem or the guidelines are wrong

1 because the models will predict a price increase in
2 situations where the merger would not even get a second
3 look under the guidelines, things that are below 1500.
4 The economists' answer is well, we are not
5 really trying to predict the price increase, we have to
6 take into effect entry repositioning and efficiencies,
7 but in fact, if you accept this methodology, then what
8 you have done is really shifted the burden of proof to
9 the merging parties, because you have said on the basis
10 of some data analysis that you have a price increase
11 unless these other factors come into play, so now please
12 prove to me that this price increase will not happen.
13 In fact, to really say to the parties in most
14 cases prove repositioning, because anybody that has done
15 a lot of mergers will know that most mergers, the
16 efficiencies that we see are not efficiencies that affect
17 the incremental costs in a meaningful way. Most of the
18 efficiencies that I've seen tend to be overhead
19 synergies. They are very important and they are very
20 real. They drive merger economic efficiencies, but at
21 the end of the day, they are not the type of efficiencies
22 you can expect to translate into a beneficial price
23 effect. Entry is kind of a defense of last resort. It's
24 very hard to show entry, particularly when you are
25 talking about differentiated product markets, where you

1 have large investments integrated with differentiation,
2 that is promotion, advertising, and also distribution
3 arrangement.
4 The parties are now in a position of being told
5 your merger is anti-competitive, you have to prove it's
6 not going to have a price effect, and really your resort
7 is repositioning. Repositioning is pervasive. It's
8 common. At the same time, we are in effect shifting
9 implicitly the burden of proof to the merging parties by
10 effectively assuming a price increase and really saying
11 the only issue is how big a price increase.
12 Another question to ask is what happens to the
13 next best substitutes analysis. We talked at the
14 beginning about what the guidelines say. The guidelines
15 say, well, we look at whether the products of the merging
16 parties are first or second choice of the large share of
17 the customers, and what we wind up with are legit models,
18 and really instead of being differentiated by product
19 attributes or by promotional issues, products are
20 differentiated by their sales level. That is the form of
21 differentiation that the analysis assumes because that is
22 really what we are looking at.
23 Of course, we are assuming identical cross
24 elasticities of all products with respect to a given
25 product, which given the assumption that some products

1 are closer substitutes to each other than others, it
2 seems to at least raise some issues.
3 The more complex models, they impose great
4 cost. They have an insatiable appetite for data. There
5 are issues with using retail level data as a proxy for
6 wholesale competition.
7 Dave Scheffman and others have put together a
8 very detailed analysis of that, and it deals both with
9 implementation issues, what do you do when a price
10 increase takes place in mid-week, but the data you have
11 collects prices on a weekly basis, as well as conceptual
12 issues, that most wholesale prices now really are two
13 part tiered and relatively fixed and a variable element,
14 and obviously consumer prices are an one part tier.
15 The issue that I guess I will end with is
16 whether these models follow the guidelines. If the
17 source of anti-competitive unilateral effects that the
18 guidelines are talking about has to do with the spacial
19 separation of product, are we really obscuring that issue
20 by looking at models that are defining differentiation
21 effectively based on the levels of sales, are we also
22 shifting the burden of proof to the merging parties
23 implicitly by doing that.
24 I was actually heartened to see that one of the
25 recent presentations Luke did showed sensitivity to the

1 cost of doing these types of analyses. The fact is
2 anybody who is doing a merger now is kind of forced to do
3 that as a defensive measure because the economists are
4 going to come to you and say, well, this is what DOJ is
5 going to be doing, and we need to do this because
6 otherwise, we are going to be unprepared for their case.
7 It's another burden of merger enforcement on top of the
8 endless boxes of documents.
9 My feeling is that the current models are going
10 to have problems in court, but at the same time, most
11 cases are decided in front of the agencies, and parties
12 will be foolhardy to ignore these models because they
13 have become part of that decision making process, and
14 what needs to be done, which is very difficult because we
15 don't have the investigative tools to look at consummated
16 mergers and see what happens and calibrate the
17 assumptions in these models to actual market results, is
18 to try to refine them and make them better.
19 MR. FROEB: Thank you, Joe. Valerie, just
20 because Joe raised this question, did you look at the
21 retail sector to see what kind of contracts they had with
22 publishers? Did they use mark up pricing or two part
23 tiers?
24 MS. RABASSA: In the Lagardere case, we had a
25 big problem to gauge that, because frankly, the sale of

1 books to retailers and wholesale was the sale of books to
2 the final consumer. We had many problems getting the
3 right data. We can talk about this problem later, the
4 problem of getting data.
5 MR. FROEB: Thank you. Greg?
6 MR. WERDEN: Before I get to my prepared
7 remarks, I want to respond to a couple of things Joe
8 said. The first one was a serious misquotation of my
9 views. He paraphrased the guidelines, which I will
10 actually quote to you, and then said I disagreed. I
11 don't.
12 The sentence I will quote says "Substantial
13 unilateral price elevation in a market for differentiated
14 products requires it to be a significant share of sales
15 in the market accounted for by consumers who regard the
16 products of the merging firms as their first and second
17 choices."
18 I totally agree that is a very nice way of
19 putting the point, notice it said significant share, not
20 a large share, I think Joe wants to switch it to large
21 share, and you don't need a large share. Second, he
22 wants to then translate this into saying there is some
23 global ranking of the products, one, two, three, four,
24 and the merging products have to be closest in this
25 global ranking. That is wrong.

1 The crucial thing to know is that typically in
2 differentiated products, different consumers rank the
3 product differently. That's why some people buy one
4 product and some people will buy another one.
5 What the guidelines say, which I totally agree
6 with, is are you using a significant number that is
7 viewed as the first and second choices.
8 Secondly, he suggested that modeling, the kind
9 that economists do, merger simulation and other things,
10 is more likely to find mergers problematic than whatever
11 it is that lawyers do instead. I find this a remarkable
12 statement because that's just totally contrary to my
13 experience.
14 One of the reasons Luke and I got into this 12
15 years ago was the lawyers had tremendously exaggerated
16 notions of likely anti-competitive effects of mergers,
17 and the only way we could think of to bring them down to
18 earth is with economic models, and it has worked.
19 In a lot of cases in which the models have
20 shown that it was implausible there would be significant
21 price effect. It was implausible they would be large
22 enough, even with very small efficiencies, that the net
23 price effect would be positive. These are cases we
24 didn't bring because of the modeling.
25 It's hard to say, because we did do the

1 modeling, but when most of the modeling said there was no
2 significant effect, we didn't bring the case, in every
3 single one of those cases that I know of.
4 I think modeling has probably kept the agencies
5 from bringing some cases, although it might have caused
6 them to bring some other ones they should have brought,
7 and in both cases, that was for the better.
8 Starting with my prepared remarks, the concept
9 of merger simulation. If the same well specified
10 oligopoly model reasonably describes the outcome of the
11 competitive process, both before and after the merger, a
12 lot of conditions, then that model can be used to
13 generate a quantitative prediction of the merger's
14 unilateral competitive effects after it is first
15 calibrated to match the prices, shares, et cetera, that
16 would prevail but for the merger.
17 All it says is if we run a model in our
18 standard tool kit that fits the industry, and we think it
19 is also going to fit the industry, except for the merger,
20 second assumption, and if it predicts what we care about,
21 like prices and maybe more, then we know how to use that
22 model. We know how to calibrate it to match the prices
23 and shares and elasticities or whatever we observe for
24 the industry, and to generate what the post-merger
25 equilibrium looks like, taking into account the

1 internalization of the competition between the merging
2 firms.
3 We can put numbers on what the guidelines talk
4 about in some cases.
5 From a plaintiff's perspective, and since I've
6 worked for the Department of Justice, that's the
7 perspective I usually take, I think that's very helpful
8 in several respects. In the first place, it's one thing
9 to tell the judge that there is a significant number of
10 customers who view the merging products as first and
11 second best alternatives, and it's quite another thing to
12 say the likely implication is they will raise price 10
13 percent.
14 I think you are much more likely to win the
15 case if you can make the latter statement than if you
16 can't, and if you have something to back it up, of
17 course.
18 Plus, there is a way to put things in
19 perspective, like cost reductions. You can trade them
20 off if you do a quantitative analysis. You can't
21 otherwise.
22 That's really my second point here in the
23 slide. There are certainly cases in which mergers may
24 have significant efficiencies or in which we think even
25 if we don't have specific evidence of efficiencies, it's

1 very plausible the merger will have some efficiencies.
2 It's very easy to take those into account in merge
3 simulation and very easy in some cases to show that
4 plausibly the net effect is a price decrease, not a price
5 increase. We don't bring those cases.
6 Merger simulation can be an useful way to focus
7 an investigation or try by identifying which factors or
8 assumptions really matter. If you can show in the
9 modeling exercise that one assumption gives you one
10 result, another assumption gives you a very different
11 result, then it becomes a very crucial fact which is
12 which of those assumptions is the right one or the better
13 one. That can be a very useful process.
14 You can also find some things really don't
15 matter much, so you shouldn't put your resources on
16 figuring those things out.
17 Limitations. The fundamental limitation is no
18 economic model is going to capture every nuance of
19 competition in the real world, but you don't have to.
20 All you have to do is capture enough to be able to
21 usefully predict.
22 Second. Price increase predictions can't be
23 any better than rough estimates. There is a whole lot
24 going on that isn't in the model. All kinds of things
25 are going to happen in the world that you can't possibly

1 anticipate. You are only given some idea of the likely
2 effect of the merger, but that's a whole lot better than
3 no idea of the likely effect of the merger.
4 Third. Merger simulation is basically designed
5 to predict price effects, possibly other short term
6 effects of the merger. It's never going to predict the
7 long run evolution of the industry, but the good news is
8 Section 7 doesn't care that much about the long run
9 evolution of the industry, which in any event, we have no
10 tools in law or economics to really predict very well in
11 most cases, so what merger simulation gives us is
12 something that the law is looking for, or what it can
13 give us.
14 The basic theme of my talk is that before you
15 use a merger simulation at trial, and for that matter,
16 before you use it for any other purpose for which you
17 give significant weight to the actual predictions, it
18 should have to pass an admissibility screen from the
19 rules of evidence. Rule 702 interpreted by cases like
20 Daubert, Joiner, Kumer Tire, and many antitrust cases of
21 less prominence.
22 What I take away from Rule 702 and the case law
23 applying it as it applies to economic testimony in
24 antitrust cases is that testimony is admissible if the
25 witness is an expert in the relevant field of economics,

1 if the testimony employs said methods from the relevant
2 field of economics, and if the testimony reliably applies
3 those methods to the facts of the case.
4 I'll elaborate these a little, mostly the
5 third. I think the required expert knowledge is a fairly
6 low hurdle. I like to quote a lot from Werner
7 Heisenberg, a famous physicist, who defines an expert who
8 is someone who knows the worse mistakes that can be made
9 in his subject and who manages to avoid them. That's the
10 kind of expertise we need in any area, including merger
11 simulation. There are some really bad mistakes you can
12 make, and you have to know better than to make those.
13 What merger simulation does is use absolutely
14 standard, well accepted tools from economics, so in that
15 sense, theoretical sense, merger simulation is the
16 application of sound methods necessarily.
17 There is also the empirical sense of soundness,
18 which can be very important, and as Luke mentioned in his
19 opening, we don't know very much about the predicted
20 accuracy of merger simulation. However, we don't know
21 very much about the predicted accuracy of anything else,
22 so in a relative evaluation, merger simulation certainly
23 doesn't do worse in predicting than anything else anybody
24 has ever come up with.
25 I won't offer some of my favorite pieces of

1 dicta from Supreme Court decisions here. First, from
2 Daubert itself, which held that expert testimony is
3 admissible only if it is sufficiently tied to the facts
4 of the case and will aid the jury in resolving a factual
5 dispute, i.e., only if there is a good fit between the
6 testimony and the inquiry.
7 Daubert didn't come up with this fit concept.
8 It was borrowed from a Third Circuit decision. I think
9 it's a very good and precise way of describing what we
10 are looking for, and it's something that certainly
11 antitrust cases are looking for.
12 The same theme expressed in a different and
13 also useful way in the Joiner case. The court should not
14 admit opinion evidence that is connected to the existing
15 data only by the ipse dixit of the expert. A court may
16 conclude there is simply too great an analytic gap
17 between the data and the opinion proffered.
18 In my view, it is not uncommon to have expert
19 economic testimony that is merely ipse dixit. The
20 economist doesn't closely tie his theories to the facts
21 of the case, and I think Joiner is right on track saying
22 this is the kind of thing that courts should not allow.
23 As an example, a very well known one from an
24 antitrust case, the testimony of Robert Hall was excluded
25 in Concord Boat because his oligopoly model, the kind

1 that you might use for simulation, although hardly
2 anybody does, was not grounded in the economic reality of
3 the industry. This wasn't the only knock on the model
4 perhaps, although I happen to read the case as saying
5 there were like six different ways in which it wasn't
6 grounded in the economic reality of the industry, so I
7 think all of the critiques were fit critiques.
8 The court said there was nothing wrong with the
9 model as a matter of theory, it was a sound method, but
10 it wasn't the right method for that case. I think that's
11 exactly the kind of inquiry a court should do, and I
12 think in the case of Concord Boat, the court was exactly
13 right, it wasn't the right model for that case, and in
14 particular, at least the way the model was calibrated by
15 Hall, it predicted that the defendant would not have more
16 than a 50 percent share without engaging in the
17 challenged practices.
18 The fact was the defendant had a 75 percent
19 share before engaging in the challenged practices, and I
20 would say that's got to be improper calibration. Not the
21 only problem with the model the court pointed out, and
22 some of the other ones I think were important as well.
23 A less well known case but perhaps a more well
24 known economist, Frank Fisher's testimony was excluded in
25 the Booksellers case for purposes of at least determining

1 damages, which was pretty important in that case, because
2 it contained too many assumptions and simplifications
3 that were not supported by real world evidence.
4 I will not comment on the merits of Fisher's
5 testimony or the court's analysis of it, because I don't
6 know enough about either one, but I will comment on the
7 language used by the court here in excluding the
8 testimony. I think this is exactly the right way to
9 think about some economic evidence and if it is the right
10 way to think about that evidence, and the right
11 conclusion is that it should be excluded. If it depends
12 on too many assumptions and simplifications that are not
13 supported by real world evidence, then it doesn't fit the
14 facts and it isn't admissible evidence.
15 What are the key elements of fitting the facts,
16 and I will emphasize these are key elements because this
17 has to be a case by case determination, depending on what
18 the facts are, what the model is, and what you are trying
19 to do with the model.
20 An oligopoly model used in simulation has to
21 reflect critical aspects of competition in the short term
22 at least. That doesn't mean it has to reflect all
23 aspects of competition. It's not going to. You have to
24 have a basis for saying it reflects the critical ones.
25 Some fact based analysis by your experts has to

1 lead to this conclusion, and he has to be prepared to
2 convince the trier of fact that he is right in thinking
3 about the industry and the model in this way.
4 The model also has to explain the recent past
5 at a fairly high level of generality, especially the
6 intensity of competition, as I like to think about it, as
7 reflected in price cost margins. There is a lot that can
8 be explained by models, how the industry has responded to
9 shocks, the level of prices as compared to costs. A
10 model should be able to explain these things, not
11 necessarily with exquisite precision. There is no reason
12 why a model should explain day to day price movements.
13 We don't care about day to day price movements.
14 The ultimate test, another way of restating the
15 fifth requirement, is that every modeling choice should
16 be justified on some basis. It could be dictated by
17 economic theory, for example, the assumption of profit
18 maximization, and needs no further justification. That
19 is what economists do. If you don't want somebody to
20 assume that, don't call an economist.
21 It can be supported by industry data, for
22 example, if the model is calibrated properly, that fits
23 the price and shares of industry, that kind of data I
24 have in mind. Also, the data may speak to diversion
25 ratios or demand elasticities. There are lots of

1 different ways in which models could be supported or
2 refuted by data.
3 It should be consistent with stylized facts of
4 the industry. How does competition work? What are the
5 important elements of competition?
6 If you have a typical differentiated products
7 case and it involves a retail sector, how does the
8 manufacturing sector interact with the retail sector and
9 how does the retail sector behave?
10 These are the kinds of stylized facts that have
11 to be studied before you can properly model an industry,
12 and you should be prepared to explain how the facts
13 support the particular modeling choices.
14 Fourth, some modeling choices may turn out to
15 be unimportant. You may be able to try a particularly
16 different choice. There may be a major difference in
17 choices. You may find out for that particular thing, the
18 model doesn't really matter. That is a perfectly fine
19 justification.
20 Finally, particularly when you can't do any of
21 the above, it may be in addition to doing some of the
22 above, you can justify a choice by doing a sensitivity
23 analysis and showing that over the range of plausible
24 assumptions, you have picked one that if your plaintiff,
25 for example, leads to relatively small price increase

1 projections.
2 There are some modeling choices in merger
3 simulation that you are not going to be able to justify,
4 and that's what you have to do.
5 A couple of illustrations. This is, I think,
6 the easiest and best one of some kind of modeling choice
7 that you are never going to be able to justify based on
8 the facts of the data, and that is what is the assumed
9 functional form for the demand curve?
10 Here I have plotted between the competitive
11 prices over in the lower right and the monopoly prices in
12 the upper left, four demand curves that have been used in
13 merger simulation. As you can easily see, going from the
14 competitive price to the monopoly price, it involves a
15 vastly larger price increase for some demand curves than
16 others.
17 Where you are going to see one of these or
18 perhaps some other functional form is when you do a
19 merger simulation, and it's going to affect in a very
20 substantial way the price increase predictions. If I'm
21 for the plaintiff, I would be using linear demand, which
22 produces small price increases, absent some strong
23 evidence I can't imagine ever having, that one of these
24 other functional forms fits better.
25 A final illustration has to do with demand

1 elasticities. In differentiated products, merger
2 simulation is a way of translating the demand
3 elasticities into price increase predictions. Obviously,
4 those predictions are sensitive to the demand
5 elasticities, and it should be obvious that we never know
6 exactly what those elasticities are.
7 Well, so you should consider what the price
8 increase predictions are for a range of elasticities.
9 Here is a very simple illustration of how that might work
10 for the WorldCom/Sprint merger, where a very strong
11 assumption about demand is made so that we can place
12 parameters on this model just based on two elasticities.
13 One is the aggregate elasticity demand for
14 residential long distance service, and the other is
15 WorldCom's firm level elasticity for its long distance
16 service. For each of these elasticities, this plot
17 considers a very wide range of plausible values.
18 The academic literature is estimated in
19 elasticity demand for residential long distance of about
20 one, and this gives quite a wide range around one, from a
21 half to one and a half. The range for WorldCom demand
22 elasticity here is from 1.25 clear up to 4, which is a
23 huge range of elasticities. It's highly likely that the
24 truth lies somewhere in that interval.
25 What this plot shows is that for some

1 combinations of parameters, a 4/10ths of a price increase
2 on up to 1.2 percent price increase for the average price
3 over the whole residential long distance, which of course
4 includes AT&T and all these other little guys which
5 collectively had, I think, around 70 percent a few years
6 ago, so WorldCom and Sprint were at least a relatively
7 small portion of the industry, significant, but
8 relatively small. So we are averaging out over these
9 other residential long distance service companies that
10 are going to have vastly smaller price increases than the
11 merging firms. That is why these numbers are so small.
12 If you down it to .4 percent, it may be very
13 easy for merger specific efficiencies to swamp that, and
14 for the net price increase to be negative. Up above one
15 percent, that's not really so likely, and that's probably
16 a price increase big enough that the agencies would worry
17 about it, and you might say very plausibly that WorldCom
18 and Sprint were closer substitutes than this model
19 assumes, if so, the price increases would be even bigger,
20 and the contrary is also correct.
21 MR. FROEB: Thank you, Greg. Joe, do you want
22 equal time now or later?
23 MR. KATTAN: I'll wait.
24 MR. FROEB: Tad?
25 MR. LIPSKY: Thanks, Luke. It's a great honor

1 to be on the same stage with such distinguished
2 practitioners of these various economic approaches to
3 antitrust, and I have to say in listening to the
4 unilateral effects theory, you would almost be grateful,
5 I suppose, that you have a merger before the Commission
6 and before the DOJ where the theory is going to be
7 innovation markets or potential competition where now
8 this is applicable and you can't do simulations because
9 you have no current output for both firms. That might be
10 nice.
11 MR. WERDEN: You need an option model.
12 MR. LIPSKY: As I said before, I think we are
13 focused on the wrong ex-Frenchman. Bertrand was an IUV
14 study, and I've said elsewhere many times before, pretty
15 much what passes for antitrust economics right now was
16 all in the original core notebook back in 1838. I don't
17 think unilateral effects were in there. Maybe it's an
18 option of the theory of monopoly.
19 I want to go at some specific issues that have
20 been alluded to but haven't been raised directly. Maybe
21 I can give a somewhat different focus.
22 Who decides and how effective are those
23 economics in this process. I'm going to back over the
24 first principles that I don't remember thinking about
25 since my first day in econometrics as an undergrad, and

1 probably I should have been thinking about them a lot
2 more than I have, but I think it helps ground the
3 discussion and reveals my approach to some basic points
4 here.
5 First, there are facts, and some facts are
6 really facts, like how much and how long it takes to
7 build a factory. There are models which are basically
8 mental constructs of mathematical models, oligopoly
9 models, what have you. I have here sort of the classical
10 model for merger law.
11 If an industry is more concentrated, the output
12 will be lower and price higher than if it's less
13 concentrated, ceteris paribus. Then there are
14 statistical tests which are propositions that grow out of
15 the application of a specific econometric method used to
16 estimate the parameters of a specific model, and I have
17 no idea what I'm saying here. Obviously, the silicon-
18 based widget market doesn't exist except in my head, but
19 this is the kind of assertion you would find at the end
20 of the articles back in the 1960s and 1970s as to what
21 you actually needed to apply econometric methods to a
22 model in a particular industry.
23 I want to echo something I heard Joe say
24 earlier. Maybe I won't put the words in your mouth. I
25 think it has do with the idea that we are all decision-

1 makers and we are not all judges, we are essentially
2 lawyers. There is a certain assumption that they don't
3 have enough economics or econometrics to understand
4 really what is contained in an assertion like that, and
5 that's one of the problems I'm going to get to a little
6 later in the presentation.
7 The value of a statistical test, the values of
8 the parameters and all those squares and all that neat
9 stuff that the economists roll around and try to persuade
10 you that what they have done is great or is viable at
11 least, let me give you a very concrete example based on
12 something we have heard today.
13 We had a description of a statistical outcome
14 for a model estimated in the context of the Booksellers
15 merger. I happen not to know a thing about that merger,
16 but I will tell you right now, if the combined market
17 shares of those two firms in the defined book market are
18 say in the 5, 10, or 15 percent range, I can guarantee
19 you I will find some problem with the econometric model
20 that was presented. If you get up to much higher market
21 shares and you talk about entry and market conditions and
22 other sort of stylized facts about the way book
23 publishing works, I would be entirely prepared to accept
24 that those statistical results are valid, but the key
25 point is that the econometric exercise is useless if you

1 have a significant reason to doubt the validity of the
2 underlying model.
3 There is sort of the red letter error type
4 thing. That's where you give your data to Greg Werden
5 and you tell him what your model was and he comes back
6 half an hour later and says, oh, you screwed up, you
7 forgot to adjust for elasticity or you have too many
8 multiple linear variables or whatever it is.
9 Even assuming that the econometrics is done
10 perfectly, it doesn't mean anything if you have a
11 significant doubt about the truth of the model.
12 I think this has had a fairly profound impact
13 in my professional lifetime in the area of merger
14 analysis, which is when I entered grad school, people I
15 think we're beginning to have doubts about this long
16 series of econometric studies showing a correlation
17 between concentration and prices or concentration and
18 profits, and looking back, I'm not sure which was the
19 more popular, based on your original structure conduct
20 performance paradigm.
21 Why is it that it was thought to apply
22 econometrics to these models 30 or 40 years ago, and now,
23 I think it would be fair to say that those types of
24 models have been fairly thoroughly discredited. It's a
25 process that not only involves "better econometrics."

1 I'm thinking particularly of Porter's 1972 Review of
2 Economic Statistics Paper, where he said, you can take
3 these regressions that are being used as evidence that
4 concentration and profits are positively correlated, and
5 notice that even though there is a claim for the validity
6 of that relationship, the statistical tests show that the
7 coefficients are small and the statistical confidence
8 intervals are rotten.
9 I've discovered one reason why that might be.
10 We divided the samples in two groups, one is sort of
11 convenience goods group, where it was sold in drug stores
12 and grocery stores, a small amount purchased at any given
13 time, very little consumer search behavior for the
14 characteristics of the product, often very subjective
15 characteristics of the product. You put that off to one
16 side.
17 The particular model that had been applied
18 worked pretty well in that set of industries, but it
19 didn't work at all in a different set of industries,
20 which was things like cars or consumer durables, where
21 you do have significant consumer search behavior and a
22 lot of the other underlying variables represented by the
23 method of retailing which were thought to be important.
24 Time marches on. It's not like you put it in
25 at one end of the lab and get it out at the other and

1 have a high degree of confidence that it's right. It's
2 much more an art, as I think somebody else said.
3 Economic model is critical to the entire
4 process of antitrust decision making because you have to
5 decide a specific case, and every litigant, as I put here
6 in the middle, every litigant tells a story, and every
7 story has a model. Sometimes the model is unstated,
8 which is very bad, and I agree with the earlier remarks
9 that the focus on the unilateral effects of the merger
10 simulation approaches sometimes gets you a long ways by
11 making the assumptions that the underlying model is
12 explicit, always a good thing to do.
13 Then the way the economic model really comes to
14 the floor in indicia decision making -- it's one of the
15 interesting phenomena, I think, in recent antitrust
16 jurisprudence.
17 In Matsushita, for example, the narrow issue
18 decided by the Supreme Court was whether an expert report
19 about the possible existence of a predatory pricing
20 conspiracy could be admitted, with the majority saying
21 no, because it's crazy, essentially, and the minority led
22 by Justice White saying wait a minute, what is the
23 seventh amendment for? A jury trial? Expert testimony?
24 What is this?
25 Justice White wanted to pretend, for purposes

1 of his very powerful decision and opinion in Matsushita,
2 that the validity of the expert's testimony was a fact.
3 I don't think that testimony was a fact. It was
4 something different. It was a model. It was a story
5 about a model. It was a story about why a model should
6 be applied to particular facts, but the fact that the
7 Matsushita majority said we are essentially entitled to
8 disregard what this expert says. I think it was
9 something of a turning point in anti-trust jurisprudence.
10 State Oil vs. Khan. There is a very explicit
11 example of saying reasoning about maximum vertical price
12 agreements was wrong and, therefore, the per se rule was
13 wrong.
14 Brooke Group is kind of interesting because the
15 oligopolistic disciplinary pricing model in Brooke Group,
16 the plaintiff's story was this is a big nasty oligopoly,
17 six firms. The smallest firm really started to discount
18 like crazy, and the third largest firm decided to lower
19 the boom on the smallest firm, confident that the leaders
20 of the market, R.J. Reynolds with 38 percent of the
21 market, respectively, would stand by that Williamson
22 discipline licit, later owned by Brooke Group, and the
23 court, maybe because they were represented by Phil
24 Areeda, but the court said that could fly, it could be an
25 oligopolistic disciplinary pricing theory under the

1 Robinson-Patman Act, and sometimes I wonder and at the
2 same time feel thankful for the fact that there aren't a
3 lot more cases. Maybe the Packers and Stockyard Act has
4 an oligopolistic disciplinary pricing theory that is
5 being tried out in this Tyson's case, but it's amazing
6 that nobody else has tried such a theory.
7 The Supreme Court says you must be covered
8 under the Robinson-Patman Act. What they said in that
9 case was that doesn't apply here. This is why I put it
10 on my list and use it for this point, Brooke Group was
11 essentially the rejection of an expert report. An expert
12 who said, I observed the factual pre-conditions for and
13 the theoretical apparatus for appreciating this
14 oligopolistic disciplinary pricing theory in this case,
15 and the court said no, that's crazy. It's inconsistent
16 with the facts, not a crazy theory, inconsistent with the
17 facts.
18 A particular fact that the court was dealing
19 with was that the main underpinning for the oligopolistic
20 disciplinary pricing theory was that the cigarette
21 industry was an oligopoly, with high prices, high
22 profits, sticky prices, sticky shares, all those things
23 we associate with oligopoly.
24 Well, it just so happens that I was senior
25 executive for the plaintiff that testified it wasn't an

1 oligopoly, prices weren't sticky, that profits weren't
2 abnormal, and I think the court had a hard time
3 swallowing the expert relying on a theory which was
4 essentially contradicted by the leaders of the plaintiff.
5 We have this weird situation where the judges
6 are deciding economic issues. They are rejecting models.
7 They are rejecting expert testimony. I think the Daubert
8 Quartet, the four cases that really form the Daubert
9 line, are in a sense an extension and may have even been
10 suggested by Matsushita and Brooke Group, chronologically
11 it works out, I suppose we will never know. Maybe 25 or
12 30 years from now when the papers are disclosed we will
13 find out, but judges are getting more and more
14 uncomfortable with economic theorizing.
15 The problem that we have is, as has been
16 previously said in the panel, the lawyers control this
17 process. The lawyers present the case. The lawyers are
18 the ones who are appointed by the politicians to hold the
19 positions at the agencies. There are just lawyers all
20 over the place.
21 Whatever economic content has been suffused
22 into anti-trust, I think there is a great deal of it, it
23 has to come through the lawyers and judges. There is no
24 existing institution that filters out the quality of
25 economic testimony and compares the relative

1 persuasiveness of different economic views of these
2 particular cases that is really designed in a way you
3 would want an institution designed, to get to the truth
4 of the matter.
5 We have an advocacy process run by lawyers. We
6 don't have time to sit around for the process to work.
7 You have some guy who is bringing cases based on the
8 notion that concentrations and profits are strongly
9 correlated, we don't have time to sit around and discover
10 that is wrong.
11 You have a failure in the antitrust realm.
12 It's not like the Challenger disaster, where the market
13 blows up and everybody says whoa, something really went
14 wrong. There are antitrust disasters.
15 I think the United Machinery case is an
16 antitrust disaster. That company driven out of business,
17 case founded, I think, are illegitimate theories of
18 violation, suing remedy. United Machinery was destroyed,
19 but it took about 10 to 20 years to happen. You can
20 debate as to whether the machinery industry was really
21 one that was destined to remain in American business
22 anyway, given all the things happening in the world.
23 I have summarized Matsushita and Brooke Group.
24 I mentioned the Daubert Quartet. I also want to focus
25 you on the sources -- judges articulate their

1 dissatisfaction with the process by which economic
2 expertise is applied during antitrust cases. They do it
3 in other cases, too.
4 Justice Breyer I don't think has ever mentioned
5 antitrust in his talking about this issue. I understand
6 he gave a talk at AEI recently on this same thing, and
7 might have mentioned antitrust. His focus is more on
8 toxic torts and that kind of scientific evidence.
9 He has basically proposed in a speech to the
10 AEA a few years ago, we really need to weed out the
11 cranks. We need to have the AEA or some responsible
12 professional body weed out the people who know what they
13 are talking about and the people who don't.
14 I'm not so sure that's a great solution for
15 antitrust. I can't imagine the American Economics
16 Association having a qualifications panel for antitrust
17 economists.
18 Judge Posner, in HFCS, a very intricate
19 exploration of the economic elements of that case that
20 were relevant to the judgment of whether there is
21 adequate evidence of conspiracy. He pretty much beat on
22 the district judge and said, look, when this goes back
23 down to explore this issue. Now that I have reversed the
24 summary judgment in favor of the defendants, it would be
25 a really good idea to use Rule 706 of the Federal Rules

1 of Evidence and appoint some experts so you can figure
2 this out at least as well and maybe better than I did.
3 If you haven't read Posner's decisions in Asahi
4 Glass vs. Pentech, and there is sort of a cluster of
5 cases that are related, you really need to read these
6 decisions.
7 Richard Posner, sitting as a district judge,
8 can you imagine, and going through unbelievably complex
9 cases involving a patent settlement and is that illegal,
10 there's some infringement issues along with other stuff,
11 you can learn about disappearing polymorphs and other
12 chemical curiosities. It's just wonderful.
13 The reason it is inserted in my remarks here is
14 that Posner makes some rather pointed remarks about some
15 theories that are now popular in the analysis of pioneer
16 generic patent litigation settlements. He is obviously
17 itching to see lower courts be more rigorous and more
18 explicit about how they confront economic modeling.
19 Just to treat unilateral effects as essentially
20 a case study of what I've been talking about, the
21 fundamental inside unilateral effects is really a
22 no-brainer. Sure, A's customers could go to B. After the
23 merger, they won't be able to go to B. How high a crater
24 do they have to climb to get out of a hole. Is that
25 going to impose any kind of long run pricing and

1 imposition on consumers? Is that going to decrease
2 performance?
3 We have already heard a lot this morning and
4 I'm not going into the fact that the analyses by which
5 you can get at these phenomena quantitatively require a
6 whole bunch of assumptions.
7 I conclude with the issue of kind of baseline
8 credibility. If we are going to continue to live in a
9 world in which the decision makers do not have the
10 expertise to decide whether a model or econometric study
11 offered is worth a darn, what is the point at which we
12 are going to allow econometric testimony to influence the
13 decisions in antitrust cases?
14 I think it's a problem. Let me suggest, and
15 here I want to run straight at an issue that Joe raised,
16 which is it's the lawyers who decide, to me, the lawyers
17 shouldn't decide. Maybe independent economists should
18 review everything that goes into an antitrust case, sort
19 of certify for the judge, not that the expert is a good
20 expert, but that he thinks the analysis is pretty
21 plausible, hasn't found any particular issue with it.
22 It's not easy to imagine institutions that
23 would effectively accomplish what I'm trying to drive at,
24 but think about that issue. Should the economist
25 actually decide? Should the judges, should the lawyers

1 be bound by what the economists say?
2 David Scheffman, who has written and I think as
3 others have mentioned this morning, the judgment on these
4 economic issues is done simultaneously, you can't
5 separate them out. Read Fred Kahn's testimony in the
6 Nabisco Brands case that was decided, where New York
7 challenged a merger that both Federal agencies had passed
8 on and found that Hippocrates was not fringed.
9 This is from the first sentence of the
10 Aphorisms, his little sayings about good medical
11 practice. Bill Baxter was a great fan of Hippocrates.
12 Do no harm. That wasn't the first sentence of the
13 Aphorisms.
14 The first sentence is "Life is short, and Art
15 long, the crisis fleeting, experience perilous, and
16 decision difficult." That applies here, too.
17 These are some criticisms I have of typical
18 enforcement agency modeling. Market definitions tend to
19 be narrow. They tend to focus on isolated time periods.
20 There tends to be, I think, heavy discounting of dynamic
21 effects, and it's wrong for obvious reasons. No one
22 necessarily does it consciously, but it tends to
23 encourage the bringing of enforcement actions where
24 otherwise somebody a little more relaxed on those
25 assumptions would not have any concern.

1 Also, there is a tendency to go to extremes.
2 We will often hear arguments in the front office that
3 make it sound as if the parties have been unable to agree
4 on anything in terms of the assumptions that are going
5 into their arguments, their story.
6 I've mentioned some of these alternatives,
7 reliance on neutral experts, Rule 706. Do we need to
8 have a category of economists who work for the agencies
9 but don't really have a role in cases, or maybe they
10 should be outside consultants, people who theoretically
11 won't have any percentage in the outcome because they are
12 not going to be involved in either the prosecution or
13 defense of the case. I don't think that's such a great
14 idea. I just raise it because this is the kind of thing
15 I think we should think about.
16 Can we get more peer review, maybe can we get
17 more industrial organization professors to look at these
18 things? I think a lot of them do.
19 Finally, my last desperate gambit, maybe a
20 Federal judicial center should be given a pot of money to
21 study all this stuff.
22 Just to remind you of why they liked the per se
23 theory, United States vs. Topco. I loved that footnote
24 that says if we were to consider the economic
25 justifications for this joint venture, it would send us

1 into the wilds of economic theory, so welcome to the
2 wilds.
3 MR. FROEB: Thank you, Tad. Greg? While we
4 are waiting for Greg, I want to ask Greg Werden a
5 question. Both Tad and Joe raised questions about merger
6 simulation, it's a seldom useful exercise, too costly,
7 too time consuming, and it's persuasive only when we are
8 using it to justify something we already know, like from
9 the totality of the facts, we know that the merger is not
10 going to raise price, here's an economic model that says
11 that.
12 Do you have any reaction to that? How
13 frequently it is used, how frequently it influences
14 decision making at the DOJ?
15 MR. WERDEN: In the first place, I don't think
16 either of them were as negative on merger simulations as
17 you suggested they were, particularly not Tad.
18 MR. LIPSKY: It's helpful to clarify. I would
19 agree the outcome is seldom very persuasive. It doesn't
20 determine the outcome and often is really not
21 sufficiently persuasive to have a major influence on the
22 judgment.
23 MR. WERDEN: I think there are two kinds of
24 major influences. One, at a very early stage, there
25 certainly have been cases where merger simulation helped

1 decide not to proceed with an investigation. Very quick
2 and dirty merger simulation, confirming what some people
3 already suspect, it's pretty easy for this merger to not
4 raise price much, to lower price, next case.
5 Also, there are a number of cases in which I
6 think sophisticated analysis was given a lot of weight in
7 the agency decision about challenging or not challenging
8 a merger.
9 MR. FROEB: Greg, go ahead.
10 MR. LEONARD: Thanks. Luke, Greg and I were
11 part of a group of economists who got the ball rolling
12 with merger simulation 10 or 12 or 14 years ago, whatever
13 it was. It quickly became pretty popular and it happened
14 quickly. I think what happens when you have something
15 that gains popularity very quickly is that a backlash
16 occurs subsequently, and I think that has happened a
17 little bit. We have been talking about some of the
18 problems.
19 I thought what I would do today is try to
20 address some of the questions that have been raised about
21 merger simulation.
22 Let me just start by saying, and this has been
23 mentioned so I'm going to go fast, basically, you have
24 the fact based inquiry, which are reviewing the
25 documents, reviewing the depositions, interviewing

1 customers, so forth and so on. Then you have merger
2 simulation.
3 They shouldn't be substitutes for each other.
4 They really should be complements. They both add
5 something to the party.
6 Merger simulation has two pieces to it. The
7 first is what I'd call guesstimating consumer demand
8 functions. You can do that with econometrics. You can
9 do that possibly by looking at documents, if the correct
10 ones are out there.
11 The second case is the model of firm behavior
12 you are going to use. People have been talking about
13 oligopoly models. That's what I mean there.
14 The two pieces together are what constitute
15 merger simulation. When I talk about it, I'm going to
16 mean to include both pieces.
17 Let me first say what does merger simulation
18 add where you have the documents. Attorneys certainly
19 like it. With economists, I would say they have value.
20 What does merger simulation add? I guess what I would
21 argue is it helps move merger analysis closer to what I
22 would call science. What do I mean by "science?"
23 The most important thing is that the analysis
24 is based on a set of theories or a theory that is
25 testable. That's really the essence of what science is

1 about. We come up with theories. We test them. If they
2 pass the test, we accept them. We keep trying to test
3 them. Eventually, they may be rejected, and we come up
4 with a better theory. That's what the scientific method
5 is all about.
6 Second, and what has been mentioned earlier
7 today, the underlying assumptions of the analysis are
8 very clearly delineated. The third thing is the results
9 of the analysis can be replicated by somebody else.
10 Finally, scientific analysis typically will
11 allow you to calculate the precision of your results. I
12 think Tad mentioned that it is conditional on the
13 assumptions, and that is certainly true.
14 Why should merger simulation aspire to be a
15 science? I guess the first thing I think as probably the
16 most important is it gets closer to objectivity and
17 further from subjectivity. That is again what science is
18 really about.
19 Secondly, it provides some certainty. If you
20 know what the rules of the game are, and that's the whole
21 purpose for the merger guidelines, I think, to lay out
22 some rules and to say here is how the game is going to be
23 played, and then gives people an idea about how the
24 analysis will go and allows them just to know how things
25 are going to fly.

1 Next is the sources of disagreement between the
2 parties, I think, are a lot more easily identified when
3 you have some scientific approaches on each side, a
4 larger definition, arguments that are based on documents.
5 There is a lot of subjectivity. There is a lot of hidden
6 assumptions, a lot of judgment. If you can instead
7 replace that with an analysis of elasticities, then you
8 are talking about hard numbers. There may be issues
9 about how you get those elasticities. Arguing about the
10 elasticities, I think, is better than arguing about some
11 vague ideas that come out of documents.
12 This is what I said before. What we are going
13 to get is bad methods are going to be replaced by good
14 methods, and good methods are going to be replaced by
15 better methods. That is the essence of the scientific
16 process.
17 Obviously, if you come out with a result that
18 is very uncertain, you are going to put a lot less weight
19 on it.
20 In large, merger simulation is in fact a
21 science or a scientific analysis. It's based certainly
22 on well established economic theory. We have the theory
23 of consumer demand that drives the demand equations. We
24 have the econometric theory that is behind the estimation
25 procedures used to get at the demand elasticities. We

1 have the oligopoly theory, which as someone was pointing
2 out, is based on infringement from many, many years ago.
3 It has been around for a long time.
4 We tend to lay out the assumptions, the
5 underlying assumptions, very clearly, and this is a very
6 important point. It says assumptions can often be
7 tested. I think that is another aspect of all this that
8 is very important.
9 For instance, the demand model you choose can
10 be tested. We can distinguish between a logit model and
11 an AIDS model perhaps, under the right conditions.
12 I can give another economist the data and I can
13 say here's what I did, and that person could hopefully
14 get the same results, replication.
15 There are going to be choices along the way and
16 we may disagree about those, but at least we know what
17 those choices are, and they are fully described.
18 Finally, you can get a standard error for a
19 predicted price change. Again, it is conditional on the
20 assumed demand models and assumed oligopoly models, but
21 hopefully again those have been subject to some testing
22 along the way.
23 The so-called document approach, it is not
24 really a science, at least in the same sense. First of
25 all, usually not incredibly well linked to economic

1 theory. Lawyers have models in their minds. I don't
2 think that's true, but they are not very well
3 articulated, and so the assumptions themselves aren't
4 laid out very well. The assumptions often aren't tested.
5 A lot of times, they don't even know what the assumptions
6 are.
7 I think if you think about what is in these
8 documents, that really is one of the problems. We look
9 at these documents and we assume that the authors of them
10 are discussing things or analyzing things in the way that
11 is actually meaningful for the merger analysis we are
12 trying to perform. I don't think that is necessarily
13 always the case.
14 If you look at the Staples case, there was a
15 certain set of analyses done. They were done for an
16 entirely different purpose. I think further analysis was
17 necessary. I think even the economists on the FTC side
18 agreed with that and went forward and did an additional
19 analysis.
20 Similarly, customer reviews are used a lot. I
21 think there are some serious problems by sampling. The
22 customers that care are the ones who come forward. They
23 may also tend to be the marginal ones. What do we make
24 of that.
25 Another problem with the documents is the

1 results can't be replicated, at least in the same way
2 that a merger simulation can be, because you are going to
3 have two different people look at the documents and
4 review them and come up with very different conclusions.
5 Finally, in terms of some questions that have
6 been raised about merger simulation. Is it a perfected
7 technique? The answer to that is clearly no. That is
8 true of almost any scientific inquiry. It's never
9 complete. It's never final. Things are always refined.
10 It doesn't need to be finalized to be useful.
11 Whatever the current state is, it can be useful in
12 certain ways, even though it may be improved upon later.
13 I think it's a theory of evolution.
14 In Darwin's original formulation, he thought
15 that evolution occurred gradually over time. When they
16 looked at the fossil record, you would find one organism
17 that clearly evolved from an earlier one, but they were
18 very different, and it was talked about as being gaps in
19 the fossil record, we were missing the fossils for the
20 organisms in between.
21 The punctuated equilibrium theory was developed
22 and basically what it said was wait a minute, evolution
23 isn't gradual. It happens in short bursts and there is
24 no change for long periods of time in between. It
25 explains the facts better, and it is perhaps a better

1 theory than the original one.

2 If you go back to the 1930s and 1940s, it

3 doesn't mean Darwin's formulation was useless. In fact,

4 it formed a lot of scientific thought.

5 The second question that comes up is does

6 merger simulation provide an answer. No, it doesn't.

7 That's one of the consequences of the fact that in this

8 science, we have to go out and test the assumptions, and

9 we might find the assumptions aren't valid. Then the

10 merger simulation is not going to be -- at least in that

11 format, is not going to work.

12 It would be impossible to capture all the

13 economic processes in a model that is going to work,

14 given we are not going to be able to do this merger

15 simulation in that case.

16 If you contrast that to the documents approach

17 where you can't always get an answer, you can get any

18 answer you want within the bounds of reason. You can

19 often get two answers, one for the defendant and one for

20 the plaintiff.

21 I would argue that because it's a science, you

22 are not always going to get an answer, and that's a fact

23 of life, I think.

24 Does merger simulation involve choices? Yes,

25 it clearly does. The good thing is the choices are

1 clearly articulated, and you can get down to brass tacks
2 and have the experts on each side argue about what the
3 right choice is. Often, the choices are subject to
4 testing. Again, very important. That's a way to resolve
5 the arguments.
6 If you contrast that to the documents approach
7 where the assumptions are often not expressly stated and
8 often can't be tested or certainly aren't tested, I think
9 there the choices are so hidden. That makes it very
10 different. And the fact that there might be disputes
11 among experts about what choices to make. It doesn't
12 make merger simulation any less a science. Scientific
13 disputes have existed forever. There are ways to reserve
14 them.
15 Is merger simulation the only co-scientific
16 merger analysis, and I would say no to that. Certainly,
17 there are other kinds of analyses that are co-scientific
18 that are helpful. We can look at what happens in the
19 industry when one firm's plant blows up and isn't able to
20 supply the market any more, and see where customers turn
21 to and what other firms do in terms of prices.
22 You can also look at what happens when there is
23 a new product introduction. There are obviously
24 complexities about these types of analyses as well, and
25 choices and everything else. In certain cases, they are

1 going to be more appropriate.
2 _FTC vs. Staples_ is an example of that, where
3 the analyses were done based on looking at markets where
4 there were a different number of competitors or where the
5 number of competitors changed.
6 Should the merger simulation approach replace
7 the documents approach? As I said at the outset,
8 absolutely not. A lot of times, you can look at the
9 documents and it is going to give you very useful
10 qualitative information that allows you to fit the model
11 better and give you institutional details, and perhaps
12 even allow you to do some testing of the model, as I
13 said, is very important.
14 What I am going to turn to is some of the
15 problems that I think merger simulation faces. The first
16 is it may not appeal to attorneys. We have heard a
17 little bit about that earlier. The first thing is it
18 really does require a fairly high level of economic
19 expertise, and I think attorneys, it may seem like a
20 black box to them. They not feel as comfortable with it.
21 Secondly, I think when you end up in a battle
22 of experts like this for each side, talking about very
23 sophisticated choices, as we were talking about before,
24 you just end up in a situation where no one understands
25 what the heck they are talking about, and the two experts

1 basically cancel each other out and the fact finder
2 doesn't pay any attention to it.
3 I think there is some of that. What Tim was
4 talking about before, perhaps having an outside expert to
5 resolve some of those things would be helpful in that
6 regard.
7 There are some that feel merger simulation is
8 too new to be attempted in a courtroom. I think it is
9 true that law tends to move more slowly than science. As
10 an example, I was thinking about intellectual property
11 damages cases.
12 What happened is you basically had to show
13 there were no acceptable non-infringing substitutes to
14 get any lost profits at all. Of course, there is this
15 reasonable royalty side of things. It doesn't mean you
16 don't get any damages, but you don't get any lost
17 profits.
18 In terms of the share based approach, it kind
19 of made things better, but again, it is based on
20 assumptions that an economist would question, I think, or
21 would want to test at least.
22 I think simulation would really help in these
23 kinds of cases and hopefully will be used sometime soon.
24 Greg already talked about this stuff, so I'm
25 going to skip that. I just want to say one thing about

1 the usefulness of comparing predictions from merger
2 simulations to actual outcomes. It is absolutely a
3 standard scientific practice to do that.
4 I have this paper with Jerry Hausman where we
5 try to do that a little bit, I think with mixed results,
6 but fairly positively.
7 Since every industry is really very different,
8 I'm not sure how much it would help to say in these five
9 industries, we have validated the merger simulation
10 approach. It's not clear to me how much that would help
11 us when we were applying it to the sixth one.
12 Finally, I guess I'll just finish by saying as
13 I said before, this is a development process, as is all
14 science, and there are clearly areas where merger
15 simulation can be improved. I think number one on the
16 list is the old Darwin model. Bertrand has taken a
17 beating today. It's absolutely true, just in economics
18 generally, it would be great to come up with a better
19 oligopoly model. I think that is really where the future
20 of merger simulation lies.
21 Thanks.
22 QUESTION AND ANSWER SESSION
23 MR. FROEB: Thank you, Greg. I know we are
24 heavily weighted towards economists on this panel. I
25 want to give the attorneys some time to rebut or say

1 whatever you want.
2 MR. KATTAN: I actually find myself in
3 agreement with most of the things that the economists
4 have said. Certainly when they critique the legal
5 method. I think they have a valid point. Their models
6 are out there. Their assumptions are clearly
7 articulated, and we can beat up on them by saying, well,
8 I have a problem with that assumption or this assumption.
9 The models that are explicitly by lawyers are a
10 lot more difficult to discern. There is certainly a
11 difference in the level of opacity, and therefore, in the
12 susceptibility of the model to questioning, and the deck
13 is stacked institutionally in favor of the lawyers,
14 largely because they control the process.
15 To me, the issue is what do I do when I have a
16 set of choices, each of which is going to predict a price
17 increase no matter what, and I'm told basically take your
18 choice, which poison do you want.
19 I would ask Greg Leonard, how do you sell to a
20 client the idea that they really have to do this, you
21 know, however many thousands of dollars it is going to
22 cost them to pay you, to come with a model that will
23 predict the price increase, next to which you will have
24 yes, but if you count for efficiencies, you account for
25 this, you account for that, that price increase will be

1 obviated or it's such a small price increase, that it
2 really shouldn't matter.
3 MR. LEONARD: I think you have to go into it
4 realizing that the model is going to predict a price
5 increase, unless those costs and elasticities are zero,
6 which is unlikely in a lot of these cases. If you get
7 one percent or two percent, it is just not enough to
8 worry about, especially because there are probably
9 offsetting effects. If they are even small efficiencies,
10 that is going to wipe it out.
11 MR. KATTAN: There is this language in the
12 merger guidelines, which I can't recite as well as I
13 should be able to, due to the fact that the five percent
14 test is not a tolerance level for price increases, and we
15 have certainly seen cases where the predicted price
16 increase was very, very small, and a challenge in fact
17 took place.
18 I don't take comfort in the prediction of an
19 one percent price increase and the argument that well,
20 you wouldn't need a lot of efficiencies to obviate. I
21 worry about my ability in most cases to show any kind of
22 efficiency that is going to bring prices down. You can
23 show significant efficiencies that are driving the deal,
24 but as I said before, they are usually going to be more
25 in the overhead category.

1 MR. LEONARD: If you go back to the guidelines
2 and say well, that's sort of how we should do things. If
3 you follow the guidelines strictly, next best substitute
4 or second, if it turns out it's the third one, you can
5 still have a price increase there, too. This is just the
6 economics of it and I don't know how you get around that.
7 I don't think following the guidelines versus merger
8 simulation saves you from that. Again, you are making an
9 assumption in there, that we don't care about it if it's
10 the third on the list. I don't know if that's right.
11 MR. FROEB: Tad?
12 MR. LIPSKY: I think part of the problem -- I
13 think there are some respectable roles for simulation,
14 making explicit the hidden assumptions is a good one. I
15 feel that a lot of these analyses, what triggered the
16 thought was the mention of the five percent. Back when
17 the 1982 guidelines were written, one of the principal
18 reservations about using the five percent SSNIP test was
19 that it would suggest an unsustainable degree of
20 precision.
21 You know, this is going to become a standard
22 and the lawyers are going to seize on this, it's a very
23 specific number used in a very specific way, and sure
24 enough, that's exactly what happened, to the point that
25 you may recall that the major feature -- there was

1 actually an 1984 set of guidelines issued by Paul
2 McGrath -- one of the major features of the 1984
3 guidelines was this big introductory statement that said,
4 now, wait a minute, you totally have the wrong idea on
5 this five percent test. Some markets could be seven and
6 some markets could be 1.5. This is just meant to suggest
7 the right question and the magnitudes we have no idea
8 about.
9 Similarly, I think, in the simulation area, if
10 you can be confident about the sign of the first
11 derivative for any of the major variables, whether it is
12 price, output or whatever, someone is going to triumph
13 from the fact that you can establish it from any modeling
14 device at all, that would be real progress.
15 I really liked the analogy to the dispute over
16 evolution. We know that even after punctuated
17 equilibrium was popularized as a theory, there are some
18 modeling gradulists who describe punctuated equilibrium
19 in a manner intended to be pejorative as evolution by
20 jerks. Of course, there are punctuated equilibrium guys
21 respond by calling the gradulists evolution by creeps,
22 which suggests something of the flavor of the debate over
23 unilateral effects theory in antitrust law.
24 The question I want to pose is this, and let me
25 say it very bluntly. My view is that most of the

1 shortcomings in the way that economics is applied to
2 antitrust decision making, it's not economics isn't
3 perfect, everybody knows all the stuff we have been
4 saying about you don't have the facts and the modeling is
5 crude, oligopoly assumptions, but just the question of
6 getting everything on the table in an efficient manner,
7 where the non-experts are in a position to judge exactly
8 what the limitations are on the analyses being presented.
9 I personally would like to see, as you could
10 tell from my presentation, I personally would like to see
11 economists somehow, and particularly neutral economists
12 as opposed to economists retained by parties, become more
13 directly involved in antitrust decision making.
14 Maybe an independent panel where the decisions
15 on the economic issues have to be in some sense credited
16 or respected by a court, or even incorporated in the
17 decision.
18 We have a bunch of economists on the platform
19 here who have had a lot of experience with use of
20 economics and antitrust agencies and antitrust cases
21 before courts. I'd like to hear whether that idea sounds
22 like a good one.
23 MR. FROEB: Greg?
24 MR. WERDEN: No.
25 (Laughter.)

1 MR. WERDEN: There are a million obstacles that
2 stand in the way, not the least of which is you don't
3 have the time. That would take extra months, I think,
4 and you don't even have extra days in most of these
5 merger cases.
6 It would be fairly expensive, but I'm sure you
7 would campaign for extra funds for the agencies to
8 support that.
9 I don't know that the decision makers who still
10 remain lawyers are going to care about the independent
11 guys. I don't know that they care about the inside guys.
12 I don't know that it would be given any weight.
13 I can imagine doing something like that, much
14 more outside of the agency than inside. I suppose if you
15 hire these people as temporary employees, you could solve
16 the confidentiality problems, but then these guys would
17 never be able to write about these things and they may
18 not want to do that.
19 Getting people to make the commitment to get up
20 to speed on these things is tough. We find it hard even
21 when we are paying people $800 an hour to get them to put
22 the time commitment in. It's not going to be easy to get
23 volunteers for this sort of thing, and it creates
24 conflicts of interest. I don't think there are going to
25 be a lot of takers.

1 Court appointed experts, I have somewhat more
2 sympathy for, but I don't think it has ever been done
3 successfully. There haven't been a lot in antitrust
4 cases, but I think never successfully. The track record
5 isn't so good.
6 I think that might make some sense,
7 particularly if what the court appointed expert was asked
8 to do is what Tad suggests, which is to tell the judge
9 does this theory make sense, is this in the mainstream,
10 what does this theory really depend on, is there some
11 fatal flaw in this that any neutral person would see,
12 that they are trying to paper over, and these two extreme
13 positions I'm getting from the two sides, which is
14 closest to the truth.
15 There are a lot of things that a court
16 appointed expert might be able to do successfully,
17 although if they are appointed the way Fred Kahn was
18 appointed, like an arbitrator, by striking people from a
19 list, you are going to get the least common denominator
20 expert, not the best expert. I don't think that is going
21 to work too well.
22 MR. FROEB: I want to turn from merger
23 simulation, which unfortunately or not, it seemed to suck
24 up all the debate on the panel. There are a lot of other
25 issues associated with unilateral effects. I wanted to

1 toss them out to our EC visitor, to Valerie.
2 Is it possible to allege both unilateral and
3 coordinated effects in a merger case? Have you ever
4 tried to do that?
5 MS. RABASSA: We have tried to do that.
6 MR. FROEB: We have 10 more minutes. I want to
7 give each of the panelists two and a half minutes, and
8 I'm going to be strict here, to sum up kind of a big
9 picture type question. What criticisms do you have of
10 the guidelines, the question of unilateral effects, and
11 what positive suggestions do you have for its
12 improvement.
13 Greg, do you want to start?
14 MR. WERDEN: I guess my main conclusion would
15 be it would be silly to re-write the guidelines. They
16 would come out worse. They always do. These committee
17 projects are not good ideas. Any one person could
18 probably do better than both of the agencies can do
19 together. My main advice always is don't write
20 guidelines, and that advice has been taken on a number of
21 occasions.
22 I don't think there is much in the way that I
23 don't like in the unilateral effects section of the
24 guidelines right now. It articulates in very general
25 terms the theories. That is what guidelines are supposed

1 to do. It doesn't say very much about the evidence.
2 That is what guidelines don't do very well. It doesn't
3 say anything about modeling.
4 Joe was suggesting a tension between what
5 economists do in the guidelines. I don't see it at all.
6 I don't think the people responsible for the 1992
7 guidelines would see it. The guidelines do not specify
8 methodology. Bring it on. Whatever methodology you have
9 that addresses the questions in the guidelines, the
10 guidelines are happy with it. That's why the guidelines
11 are useful, because they are not a straight jacket for
12 merger analysis. Any economic analysis anybody comes up
13 with that addresses those issues in the guidelines is
14 acceptable. Of course, it has to pass certain screens
15 and it has to be sound methods. Bring it on.
16 The one thing I don't like in the guidelines I
17 guess, and that's only because it is misunderstood, is
18 the 35 percent. There is no 35 percent safe harbor in
19 the guidelines. Read the sentence as often as you want.
20 It is never going to say this is a safe harbor.
21 It is going to say something else that people
22 can take to be a safe harbor, but the economists who were
23 involved in crafting those sentences made sure it wasn't,
24 and since it just does more damage than it's worth, I
25 would just cross that out.

1 MR. FROEB: Joe?
2 MR. KATTAN: I actually agree with much of what
3 Greg said, and in particular, I'm not sure that we could
4 do much better with the current guidelines, which do
5 address the issue at a level of generality that I think
6 is appropriate.
7 Jim Rill has voiced some of the similar
8 criticisms that I have, so I don't think it's necessarily
9 true that none of the people involved in the 1992
10 guidelines have concerns about modeling, but it's
11 absolutely correct that the guidelines say absolutely
12 nothing about modeling, and I'm not saying the simulation
13 approach isn't appropriate, but I think it is the case
14 that it necessarily asks a somewhat different question
15 than the guidelines do, whereas the guidelines focus on
16 the spacial separation based on qualitative attributes,
17 product attributes, marketing attributes. Many of the
18 simulations define differentiation by necessity based on
19 market share. That is the significance of firms is based
20 on market share.
21 The 35 percent issue, Greg is right that if you
22 read the language very closely, and read like safe harbor
23 language, on the other hand, has there been a case since
24 1992 where unilateral effects have been alleged under 35
25 percent?

1 The reality may be different. I think it is
2 the case that most people do view it as a safe harbor.
3 MR. FROEB: Greg?
4 MR. LEONARD: I guess I wouldn't want to stop
5 at the 35 percent, getting rid of that, and getting rid
6 of shares altogether with differentiated products, then
7 they really just are entirely meaningless.
8 I think the guidelines are trying to use some
9 terms that a lot of different people can understand, and
10 lawyers and the companies that are thinking about merging
11 and so forth. Aside from the share issue and the 35
12 percent, I probably wouldn't change anything either.
13 MR. FROEB: Valerie, I am going to open it to
14 you. You can talk about our guidelines or the newly
15 promulgated EC guidelines. Feel free. Do you have any
16 suggestions for change? Big picture?
17 MS. RABASSA: After only two weeks, we have to
18 wait.
19 MR. FROEB: Tad?
20 MR. LIPSKY: I guess I don't have any problem
21 with the way the guidelines are written. The problem
22 with simulation and types of analyses that are made in
23 support of unilateral effects approaches are lack of
24 realism in the underlying model of behavior and the
25 dynamic assumptions.

1 This broader institutional problem, which I
2 think allows the first problem to survive, to continue,
3 which is that decision makers, because they are lawyers,
4 are essentially free to ignore what the economists are
5 telling them. The solutions ultimately we are trying to
6 get to is again analyses that are closer to the truth,
7 and I think the way to do it is to make it less easy in
8 some way for decision makers to ignore what the
9 economists are telling them, but, also, I think there is
10 a degree of want of a better term, no insult intended,
11 the conversation between the contending economic theories
12 needs adult supervision, both within the agencies and
13 before courts.
14 We have touched on some of the institutions
15 that might be used to accomplish that. That, I think, is
16 the direction to look for, a discipline that will
17 facilitate scientific progress.
18 MR. FROEB: I am going to give the last word to
19 Dave Scheffman, who is sitting here.
20 MR. SCHEFFMAN: This is a very good panel, a
21 lot of good discussion. It did focus too much on
22 simulation. Very clearly, the simulation models really
23 aren't so complicated. It is sometimes A and B and some
24 equilibrium conditions and stuff.
25 What you don't think about is the A/B model

1 doesn't necessarily mean there is going to be a price
2 increase. In fact, I think one of the problems with the
3 lawyers is in industrial markets where the lawyers will
4 chase unilateral effects cases on seemingly just as good
5 as a basis, the economists will chase them off,
6 competition is much more complicated, you can't look at
7 it that way, but all of a sudden you say brand, and all
8 of a sudden you have a theory that works.
9 I keep saying the economists -- I don't think
10 it is true because most times economists and agencies are
11 doing both simulation and you have some other economists
12 actually getting into the details of competition, you
13 have to do that in either case. Simulation can be
14 useful, but I caution you and I keep saying this, A and B
15 analogy is very good and there is nothing wrong with the
16 guidelines. It's a rebuttable presumption. It's
17 rebuttable all the time in industrial products mergers.
18 Economists don't seem to forget that when they estimate
19 demand elasticities.
20 Let me give you one example. There are a lot
21 of problems with retail versus wholesale. I have been
22 working with soft drinks for over 20 years, and I am not
23 convinced there is a substantial percentage of people who
24 are in between Coke and Pepsi when prices are near a
25 parity. That is the demand curve is very flat. No one

1 estimates a demand curve like that.
2 That is just one of many reasons why you think
3 about why this theory may not work. Actually, the demand
4 curve may be very flat, may have kinks, whatever.
5 Those are the things we worry about in
6 industrial products mergers, because we ask the customers
7 and they say, well, I'm actually not worried although A
8 and B are my two premier qualified suppliers, because I
9 can get it somewhere else. We say, well, that doesn't
10 work.
11 We need to think some more about the
12 fundamental theory in the guidelines. There is nothing
13 wrong with that, but it's a rebuttable presumption. We
14 need to think about as to whether it is right or not.
15 MR. FROEB: On that note, I want to thank all
16 of the panelists and the audience.
17 (Applause.)
18 (Whereupon, at 12:30 p.m., the workshop
19 recessed for lunch.)
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1 **A F T E R N O O N S E S S I O N**

2 **COORDINATED EFFECTS**

3 MR. KNIGHT: Good afternoon and welcome to the
4 panel on coordinated effects. Coordinated effects
5 analysis might be best summed up by the observation that
6 predictions are tough, especially about the future. Of
7 course, Section 7 of the Clayton Act calls for predictive
8 analysis, and the Agencies have invested great effort
9 over the years in an attempt to answer the often
10 difficult question of whether a particular merger is
11 likely to enhance or diminish competition in the relevant
12 market.

13 Historically, much of that focus has been on
14 concentration. Indeed, concentration continues to serve
15 as the threshold test for coordinated effects. However,
16 as the 1982 Merger Guidelines recognize, and recent
17 agency pronouncements confirm, a lot of the concentration
18 data provided a starting point for analyzing the
19 competitive impact of the merger.

20 What comes next with regard to coordinated
21 effects analysis is the topic of this panel. The Merger
22 Guidelines consider two theories of competitive harm,
23 unilateral effects and coordinated interaction.

24 During the 1990s and continuing through today,
25 much has been written and said about the coordinated

1 effects theories and various approaches to assessing
2 coordinated effects of mergers.
3 Recently, both agencies have significantly
4 renewed their interest in the analysis of coordinated
5 effects.
6 This panel represents a continuation of that
7 effort. Today, we are delighted to have a full list of
8 esteemed guests.
9 Deborah Majoras is with the law firm of Jones,
10 Day, Reavis & Pogue, where she practices in the area of
11 antitrust law, among others. From April 2001 to the end
12 of last year, Debbie served as Deputy Assistant Attorney
13 General at the Department of Justice Antitrust Division.
14 During her tenure at the Justice Department, Debbie's
15 responsibilities spanned the civil, international and
16 foreign -- she oversaw numerous matters involving a
17 myriad of industries, from software to financial networks
18 to defense, health care, media and entertainment, to
19 industrial equipment.
20 In addition, she served as the chair of the
21 International Competition Networks Group and oversaw
22 policy initiatives such as the DOJ's review process
23 initiative, best practices project, the merger remedies
24 manual, and the day to day DOJ/FTC health care hearings.
25 She was often a frequent speaker on behalf of the DOJ.

1 In her current practice, Debbie actively speaks
2 and writes on antitrust issues.
3 Dr. David Scheffman has recently rejoined LECG
4 as a director, after a second stint with the Federal
5 Trade Commission as Director of the Bureau of Economics.
6 He is also a professor in business strategy and marketing
7 at the Undergraduate School of Vanderbilt University,
8 where he was a chaired professor in the 1990s.
9 Dr. Scheffman is a noted scholar in the area of
10 antitrust economics, among others, and has written
11 several important articles and books.
12 In his most recent role as Director of the
13 Bureau of Economics, David was instrumental in
14 stimulating quantitative analysis in antitrust
15 investigations, promulgating best practices for
16 interaction between the Bureau of Economics and outside
17 parties, including economic and financial consultants.
18 Dr. Andrew Dick is with Charles River
19 Associates. Prior to joining CRA, he was the Acting
20 Chief of the policy section at the Antitrust Division.
21 While at the Justice Department, he directed the agency's
22 re-evaluation of coordinated effects analysis for merger
23 investigations, and he prepared to serve as the
24 Division's testifying expert in coordinated effects
25 merger investigations.

1 Andrew has worked on a wide range of merger and
2 non-merger projects on electronic networks, steel,
3 broadcast and media, computer software and services,
4 insurance and health care.
5 Dr. Steven Salop is a Professor of Economics at
6 Georgetown University Law Center in Washington, D.C.,
7 where he teaches economics and economic reasoning and the
8 law. He is a consultant to Charles River Associates,
9 focusing on microeconomics and regulation. He has
10 written numerous articles on various areas of economics
11 and law, exclusionary conduct, joint ventures and tacit
12 coordination.
13 His research has focused, among other areas, on
14 various aspects of mergers and joint ventures, including
15 market definition, ownership interest, and efficiencies.
16 It also includes telecommunications, electronic commerce,
17 computer hardware and software, financial services and
18 consumer products.
19 Dr. Jonathan Baker is a Professor of Law at
20 American University's College of Law, where he teaches
21 courses in the areas of antitrust and economic
22 regulation. From 1995 to 1998, he served as the Director
23 of the Bureau of Economics at the Federal Trade
24 Commission. From 1993 to 1995, he was a Senior Economist
25 at the Council of Economic Advisors in the Executive

1 Office of the President.
2 Dr. Baker has served as Special Assistant to
3 Deputy Assistant Attorney General for Economics at the
4 Antitrust Division of the Department of Justice, and as
5 Assistant Professor at Dartmouth's Tuck School of
6 Business Administration, as well as Attorney Advisor to
7 an Acting Chairman of the Federal Trade Commission.
8 Professor Baker is currently involved with the
9 American Bar Association's division for antitrust law,
10 and is a senior consultant with Charles River Associates.
11 Paul Yde is with Freshfields, a newly
12 established antitrust group in Washington, D.C. as of May
13 of 2002. He is the current chair of the antitrust
14 practice group. He has served as advisor to two Federal
15 Trade Commissioners and as a litigation attorney in the
16 FTC's Bureau of Competition.
17 In addition to being recognized as a leader in
18 antitrust law, he has been active in the leadership of
19 the antitrust division of the American Bar Association,
20 he's been a speaker and author on antitrust issues, and
21 he has sat on the editorial boards of the Antitrust Law
22 Journal and Antitrust Magazine.
23 As the moderator of the panel, I will attempt
24 to lead the discussion through a number of relevant
25 issues. While my questions may actually be addressed to

1 actual panelists, all panelists are encouraged to jump in
2 the discussion at any time and pose questions of their
3 own.
4 With that, let's go ahead and get started.
5 Perhaps as good a place as any to begin is the discussion
6 of the definition of coordinated effects. What do we
7 mean? The Merger Guidelines focus on assessment of
8 whether a merger may lessen competition, and I want to
9 start by asking David Scheffman, is that an appropriate
10 definition?
11 MR. SCHEFFMAN: Thanks, Mike. Sorry for the
12 long introduction. I should have given you an
13 abbreviated bio. I am going to try as always to be
14 provocative. I've given a handout. I'm not going to
15 talk about all of this.
16 Let me step back to the beginning, to my
17 beginning in antitrust. When I came to the Commission,
18 and Steve Salop was here, too, when I came to the
19 Commission, we were litigating the Cereals case, and both
20 of the antitrust agencies had very active enforcement
21 efforts against oligopolies.
22 If you think about what was in the Cereals
23 case, which I am not a big fan of, but it was a very
24 interesting case. If you look at how the Commission and
25 what the litigation was about in that case, and looking

1 at how we analyze mergers in concentrated industries now,
2 there is a total disconnect. That is partly what I want
3 to talk about here.
4 I am going to jump to slide three, and partly
5 this has happened as a result of the focus on unilateral
6 effects.
7 We say that it's true formally that the models
8 that we use in unilateral effects are "oligopoly" models.
9 What I learned back in the dark old ages of economics, is
10 they are the most primitive oligopoly models. These are
11 models that do not include exactly what you think might
12 happen in industries that we typically review these days
13 for mergers. Specifically, in Cournot and Bertrand, the
14 assumption, which everyone realized must not make any
15 sense in a concentrated market, is that each competitor
16 assumes that its actions do not stimulate reactions by
17 the other competitors.
18 Economists have known for almost 100 years that
19 this assumption probably doesn't make sense as analysis
20 of real behavior in concentrated markets, but that is the
21 sort of analysis we have in unilateral effects including
22 in "oligopoly" models like Cournot and Bertrand.
23 In fact, game theory is much richer than
24 Cournot and Bertrand.
25 Some people have said unilateral effects is all

1 you need because if you build coordinated interaction on
2 top of that, it is even worse, so if you have a case with
3 unilateral facts, then you have a coordinated interaction
4 case, too. That could be true under some particular
5 models. However, what we see in many concentrated
6 markets is much more competitive behavior than what we
7 predicted by Cournot or Bertrand, because a lot of the
8 behavior is not about picking a price on a demand curve,
9 but trying to shift your demand curve at the expense of
10 your rivals.
11 What happened in coordinated interaction, i.e.
12 oligopolistic interdependence? In the 1980s, there were
13 a lot of coordinated effects cases, primarily because of
14 the level of concentration. They were, in fact,
15 collusion cases. The analysis was the checklist and
16 arguing about whether or not collusion was possible in a
17 given industry and in a more casual manner, what the
18 merger might have to do with that.
19 The most complete record of that is the case in
20 which the Bureau of Economics memoranda were actually
21 discovered by the other side, and you saw the big tension
22 between the lawyers and the economists about this.
23 What has happened since? Coordinated
24 interaction has gotten some renewed emphasis with the new
25 Administration, although it really had never gone away.

1 What is it based on?
2 If we go back to the 1982 Guidelines, the
3 theoretical foundation of the 1982 Guidelines was
4 Stigler's theory of oligopoly. Stigler's theory of
5 oligopoly was a brilliant paper, but it was a theory of
6 collusion. What occurred since the Stigler paper we have
7 the development of dynamic game theory. There are a lot
8 of results in dynamic game theory. You can get almost
9 any result. So, it's not very helpful. But, the focus
10 of dynamic game theory, particularly as to antitrust, is
11 on collusion games. But there are a lot of "things" in
12 between collusion and perfect competition.
13 What I am suggesting is that we need to go back
14 to something like oligopolistic interdependence, not
15 tacit collusion. Collusion theory doesn't usually really
16 fit the merger situation, although there are few
17 situations where it does fit.
18 What we should be analyzing is whether the
19 industry, or the oligopolistic coordination in this
20 particular concentrated market is likely to lead to
21 adverse effects as a result of the merger, not the tacit
22 collusion test, which is too strong a test.
23 I think what we don't know is what we mean by
24 non-unilateral cases. What we tried to convey in the
25 Scheffman/ Coleman paper is the different categories of

1 cases, types of cases. One category which I would add is
2 situations where we have the oligopolistic coordination,
3 which seems to lead to what is the ideal competitive
4 circumstances that might be adversely impacted by a
5 merger.
6 These are the things we should be concentrating
7 on. I think that is what the agencies actually do. I
8 think that's what the attorneys actually focus on. I
9 think in coordinated interaction cases, what the
10 attorneys are focusing on in most cases these days is
11 what is the actual nature of competition. They are
12 trying to prove, for example, in a unilateral effects
13 case, not that A and B are the closest substitutes, which
14 often these days is not the primary test, but that they
15 are particularly close competitors.
16 In non-unilateral effects cases, they are
17 looking for evidence that the parties to the merger in
18 some sense are behaving "cooperatively."
19 This is the area that I think the economists
20 could have the most impact, in theoretical presumptions
21 of theories, which don't really explain very much of what
22 we are actually trying to analyze.
23 MR. KNIGHT: Thank you. Jon?
24 MR. BAKER: Thank you.
25 Let me first respond by trying to put this in a

1 little bit of perspective. What are the stakes? Why are
2 we debating what is coordinated and what is not? The
3 issue is how do we make sure we are applying the correct
4 economic analysis?
5 I guess in listening to you talk, Dave, it
6 seems like you think coordinated and unilateral are dirty
7 words, and there is some third category that we don't
8 fully understand without a model, and that's where all
9 the cases are. I'm not sure I fully understand that yet.
10 I'm going to have to go back to your paper to see what's
11 there.
12 I want to stick with what we do in the
13 Guidelines with coordinated and unilateral. I think it
14 is a mistake to interpret the recent reinvigoration of
15 coordinated competitive effects analysis as somehow
16 reflecting questions as to the soundness of unilateral
17 effects analysis.
18 We want to focus on the technical issues in
19 coordinated effects analysis here; the outcomes you get
20 when the firms are following strategies that take into
21 account the past conduct of their rivals. These are the
22 kind of outcomes that are represented as a result of
23 oligopoly supergames, and they can differ from
24 oligopolistic interactions, because punishment threats
25 can support less competitive outcomes, if the firms are

1 able to identify and reach those outcomes.
2 That's why when we do coordinated effects
3 analysis, we are spending a lot of time thinking about
4 whether firms can reach a consensus on coordinated
5 effects outcomes.
6 There are a bunch of examples of in the
7 Guidelines, and when I was working on cases in the
8 Antitrust Division and working under the 1992 Merger
9 Guidelines and other cases at the FTC.
10 MR. SALOP: You all might be surprised but I am
11 actually in sympathy with what Dave says here, the way he
12 framed it today. You have to understand, Dave and I are
13 both old guys. You have to put this back in the context
14 of the sort of models that we learned when we were in
15 graduate school, back before there were graduate schools.
16 Basically, what Dave is talking about is what
17 used to be called conjectural variation models. You
18 start off with a basic unilateral effects model and you
19 expand it by saying there is some conjectural variation,
20 that if firm one raises price, then firm two will react
21 by changing its price a particular way, and firm one will
22 anticipate that reaction of firm two. They are more
23 complex sort of Nash-Bertrand equilibrium models.
24 I think we need to think about those models. I
25 think as a modeling strategy, the unilateral effects

1 model is closer to the sort of modeling we do and closer
2 to sort of the intuition we have when we are thinking in
3 terms of conjectural variations.
4 In addition, this notion of conjectural
5 variation, not stating it as such, but conjectural
6 variations are contained within the 1992 Merger
7 Guidelines in analysis of unilateral effects.
8 MR. KNIGHT: Andrew?
9 MR. DICK: I'd like to echo the point that Jon
10 was making. I think at the heart of coordinated
11 interaction theory really is the notion of repeated
12 interaction. If you look in the Guidelines, I think the
13 critical phrase is that a coordinated effect arises from
14 strategies or actions that firms take that are only
15 profitable because of accommodation by rivals, or an
16 expected accommodation by rivals, and a mutual
17 accommodation arises most naturally when there is
18 repeated interaction amongst firms.
19 Think of the three sort of tasks which Jon
20 briefly mentioned that are mentioned in the Guidelines
21 that would-be conspirators have to accomplish.
22 First, they have to reach some kind of
23 understanding or terms of coordination, talking about
24 actions they are going to take in the future that are
25 conditional upon an expectation that each firm is going

1 to accommodate each other's activities. There is already
2 a natural forward looking event there.
3 The second task that they have to successfully
4 accomplish is monitoring whether there has been
5 compliance with that agreed upon accommodation. Again,
6 the notion is over time they are going to learn whether
7 they can trust one another. Again, repeated interaction
8 is key.
9 The third task, of course, is in the event that
10 there is deviation from the agreement, they have to have
11 a way to punish. Again, that's forward looking. If we
12 are in the last period of competition, there is no scope
13 for punishment and everything unravels.
14 I would agree with Jon that there is a very
15 simple and elegant point made in the Guidelines, which is
16 that all the profitability of these coordinated
17 strategies is contingent upon accommodation, and
18 economics, and game theory in particular, has repeated
19 interaction as being essential to that.
20 MR. KNIGHT: Let's move to the Guidelines for a
21 moment. They do focus the analyst on looking at the
22 post-merger market, in particular, whether it is one that
23 is conducive to coordination -- conducive to reaching
24 terms, to monitoring and punishing.
25 They refer folks to what has been called the

1 Stigler-Posner checklist of factors, to look at that
2 post-merger market and try to determine if it's one that
3 is conducive to coordination. Those factors include the
4 availability of routine information concerning market
5 conditions, transactions, and competitiveness,
6 characteristics of buyers and sellers, characteristics of
7 typical transactions, and whether there has been previous
8 collusion.
9 Let me start with you, Steve. Is that still an
10 appropriate way to go about it?
11 MR. SALOP: Every fact we get is one more
12 brick, one more brick in the understanding of the
13 dynamics. I think this sort of simple checklist that we
14 have has really a lot of shortcomings. There are several
15 types of shortcomings.
16 First of all, the screens in the checklist are
17 imperfect. For example, with respect to the HHI, we know
18 that there is often substantial competition despite high
19 HHIs. The opposite is also true, there has been
20 successful price fixing in markets even that have safe
21 harbor HHIs.
22 Take list versus negotiated prices. The
23 checklist said list prices and don't discount, where
24 there were competitive concerns. That's true. Price
25 fixing conspiracies in many industries are with

1 negotiated pricing. Acidic acid, vitamins, and so on.
2 Even if the prices are individually negotiated,
3 as we learned from Mr. Wilson in the ADM movie and
4 Weissing movie, we know if you can monitor quality, then
5 you don't have to look at prices at all.
6 It's the same with many of the other elements
7 in the checklist. Excess capacity. While on the one
8 hand excess capacity can reduce the likelihood successful
9 coordination by giving firms a greater incentive to
10 cheat, but on the other hand, excess capacity increases
11 the likelihood of coordination by increasing the ability
12 of firms to punish.
13 Big buyers. Big buyers can keep the market
14 competitive, but big buyers can also induce to sellers to
15 raise the costs.
16 Even efficiency benefits in a coordination
17 model, we think cost savings generally reduce the
18 likelihood of coordination by giving the firm who reduces
19 its costs a greater incentive to cheat. On the other
20 hand, the cost savings increase the ability of the merged
21 firm to punish its rivals who defect from the agreement.
22 Even the Department of Justice in 2001
23 recognized that cost savings can increase cost similarity
24 across the firms and thereby increase the risk of
25 coordination.

1 All these factors can go both ways. There are
2 serious interaction effects. I think everyone agrees
3 that the longer the detection lag, the less likely the
4 coordination will succeed.
5 I think everybody also tends to agree that
6 product homogeneity tends to facilitate coordination by
7 ensuring a rapid response to the event of cheating.
8 If long detection lags, then product
9 homogeneity increases the event of cheating because you
10 have more to gain.
11 I think the checklist is just too simple to be
12 relied on for more than just a guide, a basic guide to
13 thinking about the industry. I would certainly hate it
14 if the agencies made a decision and said, well, we have
15 five in this pile and three in this pile, so we are going
16 to bring the case, and it would be even worse if they
17 say, oh, I have at least one in this pile, therefore, the
18 policy maker might say I have discretion to come out in
19 either direction, so I don't need to worry about the
20 facts at all.
21 MR. KNIGHT: Debbie, are the checklist factors
22 useful?
23 MS. MAJORAS: Yes, I think the checklist
24 factors are very useful. I know that David Scheffman has
25 shared some views. I'm going to defend the Guidelines a

1 little bit on a couple of fronts, not entirely, but a
2 little bit here.
3 First of all, the checklist is a misnomer. If
4 it's true that the agencies were doing what Steve Salop
5 just said, and sort of making a list on this side and
6 this side, and whoever has the most, that's the way it
7 comes out, then sure, I would agree that would not be a
8 particularly responsible analysis.
9 Starting with just what the Guidelines say,
10 maybe I'm reading it differently from everyone else, but
11 they say "depending upon the circumstances, the following
12 market factors among others may be relevant." How many
13 wiggle words do you need? And then when you go through
14 it, it's not a checklist of just very specific market
15 facts.
16 For example, it says you have to look at
17 marketing and pricing practices, characteristics of
18 buyers and sellers, characteristics of typical
19 transactions.
20 The number of firms that I have seen, and there
21 are those of us at DOJ who have worked very closely with
22 Andrew on working on some analysis on coordinated
23 effects, many of the things we are talking about that
24 need to be done in a rigorous analysis are within the
25 Guidelines. In fact, if you look at what Joe Simon said

1 about the cruise lines investigation and the analysis
2 that was done there, he says in his speeches, that was a
3 very straightforward application of the facts to the
4 Guidelines, Guidelines to the facts.
5 I don't mean to argue about semantics, but I
6 think we do have to be careful when people say throw out
7 the checklist.
8 The other thing that we need to remember any
9 time we talk about risks of common characteristics that
10 might be red flagged for an agency, red flagged for
11 counseling clients, is the following. A lot of the
12 antitrust work and analysis that is done, very important
13 antitrust analysis, is done two times.
14 First of all, with counsel counseling their
15 clients well before the agencies have ever heard about
16 it, well before it has hit the press, when there hasn't
17 yet been time for a truly extensive market analysis. But
18 in fact, you have a client who wants to know is it even
19 worth my trying this thing. That's the first place.
20 The second is within the first 30 days at the
21 agencies. If the agencies can't have some factors that
22 we can agree on that are at least red flags, that if
23 those are not present, the agencies could then have some
24 comfort based on other factors, including market share
25 and concentration and entry and the rest, gee, this isn't

1 one where we need to keep going, issue a second request
2 and go forward, then we may be in trouble because a lot
3 of work is done in that first 30 days. I think the
4 system depends on a lot of work being done in the first
5 30 days.
6 MR. YDE: Let me just add to that. Debbie
7 stole most of my lines. The question here is what our
8 objective is. If we are talking about revising the
9 Guidelines, changing the way that we organize evidence,
10 to move away from the checklist and design something
11 else, that's one thing.
12 If we are talking about actually changing what
13 economic theory we actually rely on in applying the
14 Guidelines, that's another thing.
15 Let's go to the first part, which is what
16 Debbie was referring to. I certainly have never read the
17 Guidelines as a checklist. We look first at the
18 underlying economic theory, that I think everybody agrees
19 is the basis for the coordinated interaction section.
20 Then we look at the standards and the objectives that are
21 stated just in that section as well as in the overall
22 purposes of the Guidelines in trying to interpret what
23 the "checklist" says.
24 I think as long as we read the Guidelines first
25 of all with the objectives in mind and understanding what

1 the underlying economic theory is, then you don't end up
2 with the Steve Salop range of factors that he suggested.
3 I guess there is a more fundamental question
4 which is what I think I didn't fully appreciate from what
5 Dave was saying when I first read his paper, which is the
6 suggestion that the theory of oligopoly, Stigler's theory
7 of oligopoly is not an appropriate theory for predicting
8 outcomes for mergers or for determining whether a merger
9 should be unlawful in predicting there is a substantial
10 lessening of competition.
11 This goes to Jon's point. That seems to me not
12 to be just a technical point. There is a technical point
13 about what kind of evidence is being used to predicting
14 anticompetitive effects, but if Dave is saying that we
15 shouldn't be using the likelihood or the possibility of
16 collusion or at least the theory of oligopoly as a means
17 of predicting whether a merger is anticompetitive, that I
18 think takes these Guidelines and throws them out and
19 starts over.
20 MR. KNIGHT: Is that what you are saying, Dave?
21 MR. SCHEFFMAN: I'm glad you said that. Let's
22 remember where the checklist came from. It came from
23 somewhere else. Posner was just brilliant about
24 implementing it. It came from the theory of oligopoly.
25 That was a brilliant paper. It was a set of conditions,

1 really the 40,000 foot level of sort of very broad
2 industry characteristics, that you could maybe make some
3 pronouncements about in a very general model about
4 whether or not they were conducive or not conducive to
5 collusion.
6 Again, that paper is the theory of collusion.
7 Lots of people have said that. It's not really the
8 theory of oligopoly. It's the theory of collusion.
9 I agree with Debbie. The agencies are much
10 more sophisticated in the use of this. The paper Mary
11 and I did said let's really get down on the ground in
12 thinking about a "checklist" sort of analysis. If George
13 Stigler would have actually applied his theory to an
14 actual industry and had all the evidence and facts we
15 have on a situation, he would have looked at the same
16 thing we do, which is look at all the factual details
17 rather than broad industry characteristics at the 40,000
18 foot level.
19 I think the checklist used in its broadest
20 sense, which is to look at the details of an industry and
21 how competition works or not, to see whether there is a
22 viable basis for coordination, is always very useful.
23 It's useful for what I'm proposing, which is worrying
24 about oligopolistic interaction.
25 The problem is that like a lot of such tests,

1 it only has power in one direction. Given certain facts,
2 it can reject the viability of any sort of coordinated
3 behavior. In cruises, which was an interesting example,
4 we had a merger with something that sounded bad to some
5 people, which is yield management, so that there must be
6 a case here. The only reason why there wasn't a case is
7 we got down in the facts and said, well, where is the
8 evidence of coordination? If we could have found any
9 sort of coordination in there, we would have had five
10 votes against the cruises merger. We couldn't find it.
11 However, if we found "it," that still would not prove
12 that the merger was anti-competitive.
13 The problem you get into these days in
14 coordinated interaction cases is the basis of the case?
15 The problem is increasingly, that the attorney not
16 surprisingly turns his focus to what is the competition
17 and to arguing that there is some oligopolistic
18 coordination, there are some things that look suspicious,
19 where if it's four to three, we have to block this
20 merger. Sometimes they are right and sometimes they are
21 wrong, from an economic perspective, and we have to
22 provide more help on the economics side.
23 That is where the real gap is. Economics does
24 not give us much to answer to that in this gray area
25 where maybe something can happen, the checklist passes in

1 a sense. There is some basis maybe that it would be
2 possible to coordinate on something. I'm not saying
3 collusion could never arise from a merger, but that's not
4 the primary problem, as I see it.
5 In mergers, we are worried about whether it's
6 going to change the nature of competition not in a
7 collusive way, and not in the particular dynamics games
8 models we are talking about, which we never see. Think
9 about those models. Look at equilibriums where the
10 collusive equilibrium is sustained because there are
11 punishment strategies and you see price wars and things
12 like that. You hardly ever see that in any real world
13 industries we see. You see it in a few. Hardly any of
14 the industries that we see do we see that. Nonetheless,
15 we see some "oligopolies."
16 That is where we have to develop more analysis.
17 This is where the attorneys run things, where the
18 economists have to have something more to say. They
19 can't say per the checklist, it fails the checklist in
20 the large, so there is no basis at all for coordination,
21 look at the data. When you have what looks like
22 coordination in some sense, that's where we have to get
23 more economic analysis into the decision making.
24 MR. KNIGHT: Jon Baker?
25 MR. BAKER: Let me first comment on what we see

1 and then what the factors in the Guidelines say.
2 In terms of the empirical economic literature,
3 what we see is that in a lot of industries, firms behave
4 so that they are not acting competitively; we reject
5 competition. There are a lot of studies that say firms
6 find some sort of way of interacting that leads to
7 outcomes that are less than competitive.
8 We also see in lots of these industries that
9 the firms are paying attention to strategies -- this is
10 the outcome of a dynamic oligopoly model of the sort that
11 coordinated effects analysis in the Guidelines is all
12 about.
13 It is perfectly plausible that the coordinated
14 interaction model is the sensible model for understanding
15 lots of oligopoly interaction without expressed
16 collusion. That is why they developed this coordinated
17 interaction model. They wanted to explain strategic
18 behavior without expressed collusion.
19 There are two issues in coordinated effects.
20 Whether the firms can solve their cartel problems,
21 whether they can reach consensus after the merger. That
22 is what the factors that we call the checklist are all
23 about.
24 There is another question about how the merger
25 changes the outcome. It's in the Guidelines, too, but

1 it's not really analyzed the way the first question is,
2 whether after the merger, the firms can solve their
3 cartel problems.
4 In order to analyze that question, you are
5 looking at a lot of factors, in terms of dynamic
6 oligopoly interactions. I agree with Paul and Debbie.
7 It's an innovative analysis of evidence that focuses on
8 the question of whether the firms can solve their cartel
9 problems, and whether they can reach consensus.
10 MR. SALOP: I don't think any serious economist
11 would say that you would like to get rid of the
12 coordinated effects section of the Guidelines. I believe
13 the issue is whether there should be an extra section put
14 in, which is called -- I don't know what to call it --
15 MR. SCHEFFMAN: Non-unilateral.
16 MR. SALOP: Dave, we will let you name the
17 section when you come back to being Bureau Director for
18 the third time.
19 If the idea is that we are anticipating rivals
20 will follow the price increase. The firms may think
21 about it in just that way, without thinking about it in
22 terms of consensus and punishment. If you have to have
23 that sort of anticipation, that sort of strategic
24 interaction into the context of consensus, deviation, you
25 are going to have trouble.

1 You would like to have a section that takes
2 that into account. I think David is right. Consensus
3 and deviation flow out of collusion, it doesn't flow out
4 of the theory of oligopolistic interaction.
5 MS. MAJORAS: Steve, you are not suggesting
6 that sort of situation has just been completely ignored
7 in merger analysis, are you, just that it's been sort
8 of --
9 MR. SALOP: I don't think it has been ignored.
10 I gave you the example of the repositioning, and the
11 example of the shampoo merger, where there was a highly
12 concentrated industry, there was decent information on
13 price. It wasn't perfectly transparent. There was
14 decent information. What was motivating the competitive
15 interaction was the fear that if you did something to
16 "restrict" output, the other people would respond by
17 entering or creating repositioning. If you raise the
18 price, you anticipate entry, in a pricing model. It is
19 within that, and you can handle it that way. By the same
20 token, us old guys, we were doing unilateral before the
21 1992 Guidelines came out. You talked about wiggle words.
22 Although you could work it in, it's certainly true
23 detailing it in the 1992 Guidelines was a major
24 contribution. When you actually write it down, you are
25 more careful.

1 I would say the typical non-unilateral effects
2 case is the case I'm talking about. You have read as
3 many lawyers' memos as I have, and they are not about
4 collusion analysis. They are about competition is going
5 to be reduced somehow as a result of this. It is focused
6 on the right question. I don't always agree with the
7 conclusion because there is no anchor there. That is
8 where we need some more economics to help.
9 If we keep talking about dynamic collusion, we
10 are never going to bridge the gap.
11 MR. SCHEFFMAN: I don't agree. I think the
12 analysis was all about whether we could find anything in
13 the data that would indicate that there was either a
14 basis or some existing sort of parallel or coordinated
15 behavior going on now. Is there evidence of oligopoly
16 now?
17 In cruises, the obvious thing which was, well,
18 why don't we just wait longer. Well, the data show that
19 was not a viable theory at all for lots of good reasons.
20 We looked for all sorts of patterns in the data. If
21 there was anything to indicate even parallel pricing of
22 some kind, then they would have been dead. We couldn't
23 find it. They would have been sued for sure if we had
24 found it. It was not about collusion. It was all about
25 whether there was some evidence that indicates some sort

1 of parallel conduct, and we couldn't find it.
2 MS. MAJORAS: David, just to round that out. I
3 agree with you. It may be that the Guidelines are
4 imprecise, not that somehow there is something so missing
5 from it that the agencies haven't been able to use the
6 Guidelines' analysis.
7 We have done it in cases where we are looking
8 at past collusion. The analysis there was a little
9 different.
10 MR. YDE: The fact that the memos that are
11 coming forward and the analysis that is being presented
12 by the attorneys -- and I'm sure also by a lot of the
13 economists -- the fact that that analysis is not well
14 grounded in the theory of oligopoly and the collusion
15 theories that are stated, or at least described, in the
16 Guidelines, that doesn't necessarily commend that
17 analysis.
18 There should be some rigorous economic analysis
19 applied, and if it was the analysis in the Stigler
20 theory, that's going to be better than just sort of a
21 suggestion that we know it's anticompetitive because
22 there is going to be a reduction in competitors.
23 MR. SCHEFFMAN: Absolutely. The Stigler theory
24 only has power to reject. You can prove, as I think we
25 did in cruises and some of the other examples, that your

1 theory can't possibly hold here, given all the
2 unsystematic noises in these industries.
3 The Stigler theory doesn't tell you when you
4 don't have -- a lot of industries actually look like
5 it -- it doesn't tell you in the situations that don't
6 look like hard core oligopolies but look actually more
7 oligopolistic in some of the outcomes, what you should
8 make the decision on. This is when the lawyers say it's
9 concentrated and looks suspicious, so we have a case.
10 That is not a proper basis, but I am saying the
11 economists have to get into the game here, and the models
12 that we are using aren't the right tool.
13 It's partly going to be empirical analysis, but
14 we also need some theoretical development to shed better
15 light on whether we have a problem or not.
16 I think the DOJ folks have advanced the ball in
17 thinking about whether the merger --
18 MR. YDE: Is there any empirical analysis that
19 suggests that the use of the Guidelines or the Guidelines
20 as they have been used, the checklist, however you want
21 to describe it, that mistakes have been made or mistakes
22 are being made, or that the change in the approach that
23 you are describing will improve results?
24 MR. SCHEFFMAN: I'm saying that the approach
25 I'm suggesting is the approach that is used. Showing

1 that numbers of competitors makes a difference, you have
2 a case. You don't need a theory other than that.
3 "Suspicious" oligopoly conduct, what the attorneys think
4 are suspicious oligopoly conduct, that is a situation
5 where the economists and the lawyers get into serious
6 arguments, and where we need some more economic and
7 theoretical analysis to do that.
8 Are there mistakes? In the enforcement
9 decisions? We know yes, because we see hardly any
10 consummated mergers that anyone is complaining about. We
11 also know that the economists disagree, much less than
12 they used to, but they disagree on some significant
13 percentage of the cases. Probably sometimes they are
14 right.
15 We don't usually get it wrong on industrial
16 mergers and with relatively small numbers of customers.
17 I'm happy to rely on the customer assessments like the
18 agencies do. We get those right.
19 Branded products. We have middlemen.
20 Supermarkets. It's not clear we are getting it right. I
21 think we get it wrong enough of the time that we could do
22 a better job.
23 MR. SALOP: That is what we call good
24 lawyering.
25 MR. KNIGHT: Andrew?

1 MR. DICK: I'm not sure in listening to this
2 discussion for the last little while that there is really
3 as much disagreement among the people up here as maybe
4 meets the eye. I think almost everyone would agree that
5 we don't want to throw out the checklist factors or
6 whatever we want to call them. At the same time, we also
7 want to be very careful in how we use them.
8 As Steve pointed out in his opening remarks on
9 this topic, on this question, clearly the checklist
10 conditions are not necessary for coordination because we
11 can observe counter examples, nor are they sufficient
12 because we can observe industries where we can count up
13 on both hands the number of favorable or allegedly
14 favorable checklist conditions and yet there doesn't seem
15 to be any evidence of coordination.
16 They shouldn't be taken literally. I have
17 always thought of them as not telling us something about
18 factual conclusions so much as sort of guide posts,
19 telling us what directions we should be looking for
20 evidence specific to an industry or specific to a market.
21 They are very handy sort of things to have in your back
22 pocket to say you know, here is where we should start
23 looking, and it is not to say this is the only place we
24 should look or if we can find and show these factors one
25 through ten, that we are done.

1 The other point that I wanted to mention is
2 that one of the deficiencies of course of the checklist
3 factors is they can be pretty helpful in describing or
4 characterizing coordination or collusion pre-merger, but
5 they are not by themselves all that helpful in terms of
6 telling us about post-merger conditions for the simple
7 reason that many of these conditions can be changed
8 directly through firms' actions, through the actions they
9 take.
10 Sometimes they can be helpful in identifying
11 pre-merger constraints on coordination, but they may not
12 tell us how the merger will relax or change those
13 constraints.
14 MR. KNIGHT: Jon Baker, we will give you the
15 last word on this particular topic.
16 MR. BAKER: Steve may want to come back after
17 this.
18 I understand where we differ, Dave, and I think
19 it's instructive. What I think I hear you saying is that
20 the circumstances of the coordinated effects category
21 applies narrowly, it's only on collusion of some sort,
22 and the circumstances of unilateral effects apply --
23 everything else, and I think you would say most of what
24 we do in merger analysis is some other category where we
25 don't have models and the Merger Guidelines don't give us

1 guidance. I just think that is wrong.
2 I find the Guidelines very helpful in
3 understanding competitive effects, including collusion
4 and competitive effects analysis, which I think is
5 important.
6 MR. SCHEFFMAN: As Greg Warden has indicated
7 and articulated, the Guidelines by their nature are vague
8 enough to incorporate anything. I don't think it's so
9 much a problem with the Guidelines. They can be
10 misleading as to actually what the practice is.
11 I don't have anything against unilateral. I
12 have a lot of problems with Bertrand, for lots of
13 reasons, and in a lot of circumstances. I don't have any
14 problem with unilateral as a more general theory, as many
15 of us might use it.
16 I do have a problem in the gray area where we
17 don't think we have unilateral, but we think we might
18 have a case because of coordinated interaction, and the
19 dynamic super games are not the answer, they are not
20 going to give us an answer to whether we have a case or
21 not, but the problem is the attorneys don't use them
22 anyway. They will go ahead and they will generate a
23 case. We need to have a better answer. The tools we use
24 don't give us much help to answer those difficult issues
25 in the four to three merger where it is difficult and

1 it's clearly not unilateral.
2 MR. KNIGHT: We are going to get to some of
3 those additional tools that we might use. Before we do
4 that, I want to take a slight detour to talk about
5 mavericks for a minute.
6 The Guidelines' coordinated effects section
7 does indicate that a merger can contribute to coordinated
8 interaction by taking out a maverick firm.
9 Jon Baker, does that analysis make sense, and
10 if so, when should it be applied?
11 MR. BAKER: It seems it should always be
12 applied.
13 When you think about the question of how does
14 the merger change the outcome, how is the constraint
15 being changed by the merger? It is all about mavericks.
16 It makes it sound like it is some sort of special
17 analysis. It comes right out of thinking about the
18 dynamic oligopoly theory, firms are going to differ in
19 all sorts of dimensions in these settings.
20 If a merger involves non-maverick firms, then
21 you need to analyze how the merger is affecting the
22 maverick.
23 MR. KNIGHT; One of the criticisms that we have
24 heard at the agencies is that the investigating staffs
25 are all to quick to label the acquired firm as a

1 maverick. Is that fair?
2 MR. BAKER: I don't know about the agencies
3 now. When I was there, I wouldn't say that. Analysis of
4 coordinated effects has occurred since I left. I know
5 there were some cases where we thought about whether a
6 firm was essentially a maverick.
7 The real focus of the agencies' on coordinated
8 effects theories has been since I was gone. It's not a
9 criticism.
10 You have to think of what it means to be a
11 maverick in order to figure out what that maverick is.
12 The concept isn't something that has some firm that is
13 observed as disruptive. These could be mavericks. Just
14 because a firm cuts price doesn't automatically make it a
15 maverick. Maybe there is a temptation for people to
16 think otherwise.
17 You have to think about whether it has a
18 greater incentive to cheat or it has a greater ability to
19 punish. There are a bunch of things you can do.
20 You can't always identify the maverick. Even
21 if you can, you aren't always sure how the merger will
22 affect the maverick. But, that is a way to think about
23 how coordination would be affected by the merger and why
24 the merger matters.
25 MR. KNIGHT: Steve?

1 MR. SALOP: I like the maverick theory, this is
2 not meant to be critical but rather to just emphasize
3 several points.
4 First, I think "maverick" is an unfortunate
5 term, because maverick gives you the idea that there is
6 someone who is not going along with everyone else.
7 It is possible that the disruptive firm might
8 be the firm with the greatest incentive to cheat, and
9 that is what is found in the Guidelines for the most
10 part, but a disruptive firm could also alternatively be
11 the firm with the greatest -- the firm with 60 percent of
12 the market, any time anybody cuts price, he slams them.
13 That firm would be the maverick. He's the one who
14 determines the equilibrium.
15 I think we shouldn't simply think about the
16 maverick as being the firm that is least likely to go
17 with the price increase.
18 We should also ask for an alternative to
19 mavericks.
20 MR. SCHEFFMAN: I like the maverick, but
21 probably not for reasons you would appreciate. I'm
22 always having arguments. I have big arguments with hard
23 core economists who think this maverick stuff is b.s.
24 I, as a strategy professor, say firms choose
25 their competitive strategies. Most of this is about

1 shifting the demand curve one way or the other. It's
2 about shifting customers to you from your competitors to
3 gain new customers. That is what I think a maverick is.
4 I think shoehorning that into the collusion
5 thing is the problem. It is not about whether the
6 industry will break out in collusion. It is that the
7 industry would be less competitive. The maverick does
8 get misused. The lawyers confuse competition with
9 meaning somehow that the merger is going to make a
10 difference. Those are not the same thing.
11 MR. KNIGHT: Let me squeeze in two questions.
12 First of all, if coordination is not the theory, is not
13 the underlying theory, why do we need principles on what
14 is a maverick? And, how do you re-write the Guidelines
15 so we make sure the maverick theory is not abused?
16 MR. SCHEFFMAN: I do think that you have to
17 have -- I think what isn't done well is developing the
18 factual basis. It really is a maverick, but this is the
19 firm that actually is making things more competitive. I
20 think if you have a factual basis showing that's true and
21 that company is being acquired by someone else who
22 doesn't have that strategy, you have a strong start to a
23 case.
24 The problem is often that what would seem to me
25 would come up is evidence that that company is competing

1 like other folks, not evidence that they are making the
2 prices lower than they otherwise would be. You can do
3 that factually, and there is some discussion in my paper
4 about that. You can do that sort of analysis.
5 I think if you have proof factually that it is
6 true that the firm is actually making things more
7 competitive, then you have a good start for a case. I
8 think very often, that is the part that is missing.
9 MR. YDE: What is the policy implication of
10 saying in the Stigler oligopoly theory that everybody is
11 a maverick? What is the policy implications for mergers?
12 MR. SALOP: It should say you should stop this
13 snipe hunt. As I said before, I think the concept that
14 you are looking for here is broader than just the low
15 price leader. It could also be the powerful one.
16 In Jon's model, the maverick is the price
17 leader. Jon mainly talked about that in his article as
18 the firm with the low cost. The leader could also be the
19 firm that prevents the price from going down. It's a
20 much broader concept than simply the price leader. Do
21 you agree with that, Jon?
22 MR. BAKER: I agree that one way you could have
23 a maverick is a firm could be indifferent between
24 cheating and colluding and therefore keep the price from
25 going higher. Another way is indifferent to punishing

1 more. Did I say that backwards? I think a maverick is
2 where he does not want to punish as much as he should.
3 I think in real world situations where firms
4 differ and the firms can't find ways to punish or to make
5 side payments, some firms are doing more of the work in
6 constraining coordination than others.
7 It seems a perfectly reasonable thing for me to
8 do to find out who the maverick is in order to understand
9 whether the merger --
10 MR. SALOP: I would hate to see coordinated
11 effects analysis to be reduced to whether a firm is a
12 maverick.
13 MR. DICK: There's a corel to this, too, in
14 terms to the response to the second question Paul asked,
15 which is there is always a firm on the cusp, there is
16 always a maverick, more than one maverick, and the
17 question is if the merger eliminates that maverick, who
18 is next in line, and if they are very similar, close in
19 terms of the constraint they place on coordination, then
20 the merger, even though it eliminates a maverick, would
21 not have a very significant effect. You always have to
22 look at the next guy and why he is going to replace the
23 guy that got knocked out.
24 MR. SALOP: Just like the next best substitute.
25 MR. DICK: Right.

1 MS. MAJORAS: I just want to come back to
2 something David was alluding to, which is I was wondering
3 whether when I was at DOJ whether I saw the maverick sort
4 of being over-used in case recommendations under
5 coordinated effects.
6 I don't think so. There is not a maverick
7 identified in every case recommendation. Sure, there
8 were some and some of those cases were brought in the
9 last year. I don't believe they were called a maverick.
10 For example, if you look in the UPM complaint,
11 the evidence showed that UPM had come into the United
12 States, had been quite aggressive, and expanded their
13 U.S. sales, and there were facts -- I should say I was
14 actually recused on that matter -- that were part of it.
15 There was also evidence that perhaps some coordination
16 had already begun, so that was an important factor as
17 well.
18 In another case that you may not have looked at
19 because it resulted in a consent decree, Alcan, believe
20 it or not, was identified as an aggressive new
21 competitor. Alcan obviously has been in aluminum for a
22 long time, but this particular product was new to the
23 United States, and there was some evidence there.
24 Sure, we saw it some of the time. We also had
25 cases in which there was evidence of past collusion in

1 markets and I don't recall searching for a maverick.
2 To the extent that we are really in
3 investigations sometimes looking for one, I think the
4 reason for that comes back to something that you have
5 been saying here, David and others, which is if the
6 question you really need to answer is why does this
7 merger matter, not just what is the structure and what
8 are the market characteristics today, and what would they
9 be post-merger, but how is this exact merger going to
10 make an impact. That is a very hard question to answer.
11 That is one of the reasons at DOJ we tried to
12 reinvigorate looking at the theories and looking at what
13 we have and looking at what we have left to do. The
14 sense was we weren't doing a very good job of answering
15 that question.
16 When you have a maverick to point to, that's very
17 specific -- this merger, this guy, is having this impact on
18 the market and presumably won't have that impact any more.
19 It's not surprising that we would fall back on
20 that, that the enforcement agencies would.
21 MR. YDE: On the definition of a maverick and how
22 you can define a maverick, who is identified as a maverick,
23 in Northwest/Continental, where I was on the other side,
24 Northwest -- I'm sorry Jon I haven't read your paper yet, I
25 did read your deposition and your expert report -- Northwest

1 was not a company that could have been so identified, at
2 least as far as I understand it, there wasn't any underlying
3 structural factors that suggested why they would be the
4 maverick. Nevertheless, it did appear, at least you argued
5 that it may have been the case and it may be supportable in
6 some way, that they had a strategy that on a repeated basis
7 they historically had not gone along with the generalized
8 price increases that were proposed in the industry.
9 I guess this goes also to your analysis, David.
10 Is it ever sufficient that you just find there is a
11 historical record of maverickness? I would think you would
12 have to identify some underlying structural factor, either
13 in its costs or excess capacity or whatever else broadly
14 defined, that suggests why after a merger its maverickness
15 being lost is important.
16 MR. BAKER: I think you are much happier if you
17 can identify why. In the Northwest example, you basically
18 had your facts right. It was hard to pinpoint it. The
19 behavior had gone on for so long and so consistently that it
20 was hard not to reach the conclusion this really was a firm
21 that for reasons that weren't clear based on market
22 structure was constraining coordination.
23 I would have been happier to have understood why.
24 It really takes a long history of years of multiple
25 incidences of doing that before I was willing to come up

1 with the conclusion in that case.
2 MR. YDE: Do you think it is important that you
3 can explain to the court --
4 MR. SCHEFFMAN: As a business strategy professor,
5 I draw on more bases than what we use in simple economic
6 models. It is going to be obvious that you have a maverick.
7 It's going to be pretty obvious and you are going to have
8 natural experiments to be able to prove you had a situation
9 where the one firm never follows the price increases of the
10 competitors and price changes are important, they show up on
11 the shelves. Then you are going to have a track record like
12 that or you are going to have in some cases a relatively
13 small share of firms that go around and are used to voice
14 the bigger firms in industrial markets.
15 A real maverick, you are not going to have to hunt
16 for. You have to prove it actually affects the prices.
17 They go around and knock on the doors and try to get
18 business. That's fine. Do they actually have an impact on
19 prices? That's the critical point.
20 MR. KNIGHT: We have talked on a number of
21 occasions here about the additional approaches and tools
22 that the agencies might begin to use to assess coordinated
23 effects. Andrew Dick was sort of involved in the efforts at
24 the agencies to reinvigorate the analysis. Can you tell us
25 a little bit about what you see the agencies could be doing

1 or are beginning to do in utilizing coordinated effects?
2 MR. DICK: Sure. I had the pleasure to work with
3 Debbie and Charles James and Michael Katz when I was in the
4 DOJ, as Debbie mentioned earlier, to try to reinvigorate
5 some of the coordinated effects thinking. It really started
6 with just trying to understand what we knew about
7 coordinated effects now and to identify what we didn't know,
8 which was equally important.
9 I think there is a sense that in the Division as
10 speeches by Charles and by Hugh and by Debbie have
11 articulated, which is there is sort of a focus on a two part
12 question. The first part is what is it that constrains
13 coordination right now before the merger, and secondly, and
14 obviously the really critical question, which is how will
15 this or will this merger in fact relax in any significant
16 way some of those pre-merger constraints, some of the
17 binding constraints?
18 That is sort of the general question the Division
19 has used to frame some of this analysis. The question is
20 now, where are those constraints found, where should we go
21 and look for them?
22 One of them we have just been talking about, that
23 is sort of the maverick firm, and more broadly, the
24 disappearance of a significant competitor, and significant
25 in what sense. The maverick is one way of looking at it.

1 Another way that people have looked at that, or have started
2 to look at it, is whether a firm might be pivotal in a sense
3 that the removal of that firm is going to significantly
4 change the incentives of say a subgroup of competitors to
5 engage in coordinated interaction, or the incentive and the
6 ability of firms, say the firms that aren't part of this
7 alleged cartel or group of conspirators, to take actions
8 that would tend to undermine coordination.
9 One can try to look at various indices such as
10 controlling excess capacity, as I think Debbie mentioned
11 briefly in the UPM case, in the complaint. In addition to
12 the factors that Debbie mentioned, there is also discussion
13 about the acquired firm representing a very large share of
14 the excess capacity in the industry. That is something that
15 the complaint emphasizes.
16 And then working that notion into whether, in
17 fact, the firm that was being acquired in that merger was
18 pivotal to the success or the likelihood of coordinated
19 interaction.
20 Another category of constraints is asymmetries
21 between competitors. In our earlier remarks, we talked a
22 little bit about asymmetries. I think Jon mentioned that.
23 Asymmetries in cost structure, in planning horizons, in
24 product positioning, geographic coverage, discount rates. A
25 lot of the factors that come up in the checklist indeed, but

1 here the question is not whether those factors are present
2 or not but could the merger in some significant way change
3 those factors, change those constraints, relax them, by
4 narrowing cost asymmetries. That was one of the
5 allegations, for example, in the Primdor Masonite case that
6 the Division brought two or three years ago.
7 A third source of constraints could be narrowing
8 the opportunities for firms to deviate from coordination,
9 and under that category, I think people usually think about
10 the degree of transparency in the market, that firms observe
11 each other's strategies and can they observe each other's
12 payoffs, which is market shares and so forth.
13 Also, the pace of innovation. Is this a market in
14 which new products are continually being introduced or cost
15 changes are continually occurring that may create
16 opportunities or lend themselves to opportunities for
17 mavericks to take advantage of openings to disrupt
18 coordination?
19 None of these concepts, I think, is particularly
20 new. Probably what the Division did, which was, I think,
21 nonetheless very helpful, was to try to add a little more
22 rigor and put them in a more structured framework.
23 I had one slide that was sort of helpful to walk
24 through one example. It relates to the point of how we
25 interpret historical evidence, which is something that has

1 been talked about already today.
2 Let me just sort of walk through it in the
3 interest of time. If we find the slide, we find it.
4 The question is, should history matter? We have a
5 history of coordination, let's say, in this industry.
6 Should it matter, and if so, how?
7 In practice, the courts have placed substantial
8 weight in many cases on historical evidence. In the grain
9 case, a history of price fixing was thought to be very
10 important. In Cardinal Health, the history of tacit
11 coordination was thought to be important. Price leadership
12 in the Heinz case that Jon worked on, and in Hospital Corp
13 of America, the notion there was cooperation, not
14 necessarily anticompetitive, but cooperation in general in
15 the past was thought to be possibly relevant to analyzing a
16 current transaction.
17 History has clearly shaped how courts have thought
18 about this and has clearly shaped how agencies have heard
19 evidence and influenced sort of where they have set the bar
20 for assessing merger effects going forward.
21 There is an empirical basis for thinking history
22 matters that is sort of grounded in some empirical evidence.
23 At its base, it's really driven by correlations, rather than
24 sound microeconomic theory.
25 In many cases, we talk about history as sort of a

1 summary statistic for unobservable information, unobservable
2 data. We don't know why firms were able to coordinate, but
3 we observed they did. That sort of gets us over the initial
4 hurdles of thinking maybe they could do it again and maybe
5 they could do it even better after the merger.
6 Starting with that base, I think one of the things
7 that the new approach has taught us is that we need to first
8 undertake sort of a reality check.
9 The empirical evidence on whether history matters
10 is actually relatively mixed. There are case studies, and
11 Jon has a very nice one in the Journal of Law and Economics
12 a number of years ago looking at the steel industry and
13 whether firms were able to learn more from coordination and
14 continue even after sort of the initial impetus for it was
15 removed.
16 On the other hand, there is lots of cross-
17 sectional evidence in studies of cartels and time series
18 evidence that indicates recidivism is relatively low or
19 rather infrequent, and when recidivism does occur, that
20 successful cartels seem to break up much more quickly than
21 the first set of cartels or the first incarnations.
22 That is a reality check and it calls a little bit
23 into question the basis for extrapolating to the future from
24 the past.
25 It also brings up the next point, the next sort of

1 lesson of the Division's new learning, which is to say we
2 have to identify very clearly the micro foundations for why
3 history might matter.
4 As Debbie mentioned a few minutes ago, the
5 critical question is how will this merger effect competition
6 or effect coordination in this market. In the context of
7 looking at the historical evidence, we have to ask, will
8 history affect coordination after this specific proposed
9 merger?
10 There are a number of good theoretically- grounded
11 reasons why history might have that effect. History can
12 help build understandings amongst firms. It can help reveal
13 the types of firms, their cost parameters, their discount
14 rates -- information that theory tells us is relevant to
15 whether coordination is sustainable.
16 History can teach firms how to coordinate. That
17 is the example that Jon analyzed on his paper on the NRA
18 codes for steel. History can also sometimes improve the
19 accuracy of current and future monitoring; say that over
20 time firms learn more about that underlying demand
21 conditions and seeing they are relatively stable may help
22 them in the future in terms of monitoring and punishing.
23 The final point that has to be added to this,
24 pointed out by the Division's new approach, is there has to
25 be a sensitivity check. We always have to ask, has history

1 changed significantly since we last looked? Has there been
2 significant entry? Has the geographic market broadened?
3 Have power buyers emerged? Have capacity constraints been
4 relaxed? Can we demonstrate whether in fact those changes
5 in the historical evidence have really led to important
6 changes, say in pricing behavior?
7 I just took this detour to talk about history as
8 one example, but I think the new approaches are intended to
9 build from the checklist approach and say is there something
10 there that might tell us about where we should look for
11 evidence, and sort of try to be realistic about it, apply
12 reality checks and sensitivity checks, and above all,
13 develop a good firm micro theoretical foundation for why
14 that factor matters.
15 MR. KNIGHT: Following on that, Dave, you talked
16 earlier about that the economists may have more to
17 contribute, particularly in assessing current markets
18 pre-merger. Can you talk to us about some ways that might
19 come about?
20 MR. SCHEFFMAN: I sort of alluded to that. I've
21 talked about it in various ways already, which is, I think
22 you need to look beyond the checklist and then said that the
23 agencies clearly do that. I think it should be clear to
24 everyone that we do, the agencies do.
25 Look at the details. We are talking about mergers

1 affecting price. That is what we are usually concerned
2 with. Where is price determined? In most of the markets we
3 look at, price is determined between the seller and the
4 individual buyer. It's not like the wheat market and hardly
5 any of the markets we look at are like that wheat market.
6 You need to look at actually the details of those
7 prices and the determination of those prices to get some
8 idea whether or not you think there is coordination
9 viability. That is the main point of Mary's and my paper.
10 Looking at the detailed transactions level data, looking at
11 in detail what information firms have from one another.
12 Mary and I had a wonderful case once where we had
13 just terrible documents that our client was the price
14 leader, all the competitors thought it was the price leader.
15 It turned out that we looked at all the data and it was
16 pretty hard to see from the data that there was any
17 leadership going on. As I tried to tell our client, it's
18 hard to be a leader if you don't have any followers.
19 What looked like from the documents a classic
20 oligopoly, that they were tracking what each other were
21 doing, looking at who they were gaining sales from and
22 losing sales to, and everything like that, and tracking that
23 by looking against the other company, there was no match in
24 the data. Looking at how they track capacity, which they
25 try to do very carefully, and then we could check that

1 against what the other companies actually did, that sort of
2 detailed analysis is clearly very relevant and it is spelled
3 out in detail in the paper.
4 To get into the details of whether you really have
5 any sort of coordination going on or you have a basis for
6 it, again, I think it's very good stuff, but it's only a one
7 way test. You can actually do that. I've worked on a lot
8 of markets that you might think are oligopolies, but the
9 data you see, say in a chemical merger, it's hard to find
10 real oligopolies these days showing up at the agencies.
11 When was the last merger case DOJ had that
12 generated a serious price fixing investigation? Not too
13 many.
14 Antitrust attorneys are going to look at, talk to
15 people and look at, the documents and say there is no way
16 you are going to do this merger. There is another reason
17 why that is not a very viable theory. You are not going to
18 see it hardly, even where it does exist.
19 I think we need to be looking at something else
20 and where we play, given the pre-screening, which is does
21 the merger make a difference?
22 MS. MAJORAS: DOJ does have one now.
23 MR. SALOP: Two caveats, I think, are worth
24 pointing out. The caveat is it has been pointed out these
25 tests are one-sided tests. All they can do is reject the

1 coordination model. You can only win, you can't lose.
2 What we need is tests that can reject coordination
3 or we need other tests that can reject competition.
4 Otherwise, the tests are really problematic.
5 The issue of whether we are going to grandfather
6 existing coordination or whether, in fact, we are going to
7 hold existing coordination against the merger. The 1992
8 Guidelines don't resolve this issue fully.
9 In my view, I don't think we should grandfather
10 pre-existing coordination, for the simple reason that absent
11 the merger coordination might break down if and when market
12 conditions change, but if you permit the merger, it could
13 entrench the coordination and prevent the breakdown in the
14 future if and when market conditions change.
15 The Merger Guidelines really do focus on the
16 incremental effects of the merger, and they never explicitly
17 say that they are worried about this entrenchment factor.
18 There is this one place, in Section 1.11, in
19 market definition, where the Guidelines say that the
20 agencies use prevailing prices, unless pre-merger
21 circumstances are strongly suggestive of coordinated
22 interaction, in which case, the agency would use a price
23 more reflective of the competitive price.
24 To the extent there is any coordinated interaction
25 or a chance of it, that means you should apply this, and

1 that means you can't do the SSNIP test based on the current
2 price, and it means critical loss, one more reason why you
3 should throw out simple critical loss analysis.
4 I don't know of any cases in which the agencies
5 have ever applied this proviso. They say maybe they will
6 use a different price SSNIP test, but I've never seen one.
7 MR. SCHEFFMAN: I guarantee you any industry in
8 which the staff has pretty convincing reason to believe that
9 prices look suspiciously high because of funny sort of
10 behavior, you are going to get a merger blocked.
11 MR. BAKER: I have one point to add to Steve's
12 comment about the prevailing price, which I basically agree
13 with. The emphasis that both of the agencies have been
14 making recently, and especially the FTC, on gathering
15 empirical evidence on issues as to whether the merger is
16 really useful.
17 There are interesting ideas about things that
18 might be tested and you can look at on tacit coordination.
19 The point I want to make about all these empirical
20 studies is that they are tied to specific theories of how
21 firms solve their cartel problems, just as what we used to
22 call the checklist factors. They have to be integrated into
23 the theory of how firms can -- the empirical studies have to
24 be conducted with what the theory is.
25 Just as the checklist factors have to be analyzed

1 with an eye towards what the theory of the case is, the
2 empirical studies have to be conducted with an eye towards
3 what the precise theory of the case is as well.
4 MR. KNIGHT: Dave mentioned a case in which the
5 documents suggested one story and the analysis, empirical
6 analysis, suggested another. What do you do in that
7 instance?
8 MS. MAJORAS: It's hard to imagine a case where
9 all you would have would be some documents and then some of
10 the empirical analyses. You are going to have a lot of
11 other factors, too. I don't think there is any question
12 that you have to take all those factors, you have to weigh
13 each piece of evidence, because obviously, that is the
14 ultimate analysis for the agencies. They are going to have
15 to go into court and prove something.
16 As you are going through and having to do a
17 balance of the various factors in the marketplace, you have
18 to weigh them and you have to weigh them against each other.
19 I don't think there is any way you can say in the abstract
20 that one is going to have more weight than the other, but I
21 will say this. If you look at courts, I think most people
22 have had this experience, courts are going to put a lot of
23 weight on the actual, on pieces of paper, on what they see.
24 They will give credence to theory, for example, but they are
25 going to put a lot more weight on the pieces of paper, on

1 historical facts.

2 We can say those damn lawyers, it's terrible that
3 we have to put up with them, but we are part of the process,
4 and that is what we ultimately have to do. It's governed in
5 the end by what you have to do in court, and that's a good
6 discipline.

7 MR. YDE: We don't want to divorce the documents
8 from the theory. What you are doing essentially with
9 documents is taking admissions in documents and formulating
10 them in theory, what is consistent with those documents, and
11 particularly other evidence that may suggest that the
12 transaction is not anticompetitive.

13 I think you want to take those admissions and
14 formulate a theory that is consistent with those admissions.

15 MS. MAJORAS: Yes, there's no question, and
16 besides that, you have to take those documents and you have
17 to analyze those in the context of all of the other
18 documents. You can't just pluck ones out of the file and
19 say this is evidence.

20 MR. KNIGHT: As these analyses move forward at
21 both agencies, how do you see this affecting the way in
22 which you counsel clients?

23 MR. YDE: There are three different things we do.
24 I think Debbie would agree. First, there is the counseling
25 on transactions, counseling up-front, making predictions

1 about what is likely to happen on a transaction in front of
2 the agency, the course of review at the agency, and related
3 to that is the way that you negotiate the provisions in the
4 merger agreements.
5 The second is the representation before the
6 agencies, and the third is litigation. I'll cut to the
7 chase on litigation. There is almost nothing that is going
8 on in the agencies that has any effect on the outcomes of
9 litigation. I'm sure the people in the agencies right now
10 would disagree with that, but if you look at the court's
11 decision in the UPM case, I think you recognize that the
12 courts aren't paying any attention to the theories that the
13 agencies -- at least the more rigorous descriptions of the
14 theories that the agencies -- are propounding.
15 On counseling, the most significant effect or the
16 most significant event in all of this for counseling a
17 client on mergers is when the leadership of both agencies
18 said we intend to reinvigorate coordinated effects analysis.
19 That was pretty much the beginning and the end.
20 Once you are told that the agencies intend to
21 focus on coordinated effects theories, you need now to take
22 that into account in the way that you are making a
23 prediction about the course of agency behavior and, also,
24 about the way you are going to negotiate the risk allocation
25 provisions, especially if you are looking at a transaction

1 in which there is likely to be a small part of the overall
2 transaction that comprises the potential coordinated effect,
3 and you know you have to negotiate something to deal with
4 that in the agreement.
5 Andrew was just describing the rigorous approach
6 and Dave described the quantitative methodologies and
7 techniques that are being applied. Does that really affect
8 the way that we are going to advise a client? I don't think
9 so. It's done at a pretty gross level, depending on the
10 things we have talked about before, a history of activity at
11 the agencies in the industry that you are dealing with,
12 especially with a company that you are taking in. Hot
13 documents, if you have any bad admissions, whether it is
14 public and, of course, customer complaints.
15 On representation in front of the agencies, it is
16 a much different thing. It affects substantially the
17 arguments you make, the representations you make.
18 I think you have to be affected by what David was
19 saying when he was the Bureau Director, what Jon was saying
20 when he was the Bureau Director, and what Andrew and Debbie
21 were saying when they were in the Department of Justice.
22 You have to know what impacts their analysis, what
23 they think is the most important way to formulate the --
24 what techniques they think are important.
25 When Joe Simons came into the agency, if you were

1 not presenting a critical loss analysis on every case you
2 had before him, you were probably making a mistake. The
3 same thing is true here. I would just suggest the manual
4 that has been put together by the Department of Justice
5 actually should be generally distributed to the general
6 public. I haven't seen it yet, but I would suggest that
7 would be helpful to everybody in predicting how the agency
8 is going to look at your deal and how you should present
9 your case.
10 It's to give guidance to the staff and management
11 about how the leadership wants the staff and management to
12 look at the case.
13 There is some feedback. You want to do some of
14 the analyses upfront to see whatever it happens to be that
15 is being suggested by the agency as being influential. You
16 want to do some of that upfront to see how it is going to
17 look when you go in.
18 It generally doesn't have a big impact on most of
19 the sort of gross level judgments you are making about
20 whether to proceed.
21 MR. BAKER: Why bother to do it if it doesn't
22 matter for the outcome?
23 MS. MAJORAS: He isn't saying it doesn't matter
24 for the outcome.
25 MR. YDE: It is the question of whether you are

1 going to proceed with the transaction or not.
2 MR. BAKER: Isn't it expensive to do this in
3 advance?
4 MS. MAJORAS: The client doesn't often give you
5 time to do two months worth of a pricing study to tell you
6 what to do. They want to know tomorrow whether you think
7 they ought to give this one a shot.
8 MR. YDE: Like most things, you can generalize too
9 much. What I said was a gross generalization.
10 MR. SCHEFFMAN: I want to clarify something Debbie
11 said, because I'm sure she didn't mean it. Documents and
12 other qualitative information are not necessarily "facts."
13 And fact-based analyses, often not econometric analysis, can
14 corroborate or disprove the "facts" appearing in documents
15 and depositions.
16 In my last stint at the FTC, we had a difficult
17 case and the attorneys really had convincing evidence. But
18 it was difficult to figure out what the market was. The
19 market is customers that have these attributes, and it
20 seemed right. That's what the documents said. However, the
21 economists analyzed got the customer lists of the companies.
22 The market wasn't anything like that.
23 MS. MAJORAS: I'm not saying that the analyses are
24 always going to come to documents. I thought I was being
25 asked a general question. You have to play them according

1 to what you have in front of you. In addition, there are
2 times where I might actually disagree with you, where I
3 might think the documents, if it is registering what in fact
4 a company thinks one of its competitors is doing and reacts
5 accordingly and that turns out to be wrong once an economist
6 comes in and does a study, so what. That firm was behaving
7 because of what it thought, it had imperfect information, so
8 that was actually relevant, even though it turned out to be
9 not the actual facts.
10 One final thing, one thing that I think is
11 interesting in counseling clients in mergers, and talking
12 about coordinated effects versus unilateral effects, I think
13 I saw some of it in the dynamic on the other side of the
14 table when I was at DOJ, and that is it is almost
15 psychological.
16 It's very hard to get clients focused sometimes on
17 the right issues when you are talking to them about
18 coordinated effects, because they take it personally,
19 because they become very angry. You can actually see it in
20 meetings sometimes on the other side, where we would spend
21 45 minutes with members of a firm explaining to us what
22 great people they are and how they are very honest people,
23 and they are never going to do bad things that would put
24 them in jail and that sort of thing.
25 I just mention that because it is sort of an

1 interesting fact. It is true, I think, when you counsel
2 clients, it takes a long time to get the client to sort of
3 calm down, not just be sort of ticked off at the agency, and
4 not just want to keep protesting, but to understand we are
5 not just talking about explicit collusion. We are talking
6 about other forms of coordination.
7 It's not going to be helpful to go into the agency
8 and tell them you have learned your lesson, you are very
9 good now, this is never going to happen again. If the
10 market hasn't changed substantially, that just is not going
11 to be persuasive.
12 They don't really understand this. They want to
13 know why did you make me put in place all these wonderful
14 compliance programs and now it isn't going to do me any
15 good. On the other hand, when we are talking about
16 unilateral effects, nobody takes it personally if you
17 suggest they might act like they are the king of the hill.
18 It is always an interesting factor, I think, when
19 you are counseling.
20 MR. SALOP: I disagree with Dave that simple
21 correlations are going to carry the day in court. That is
22 what econometrics is all about. One side puts in a simple-
23 minded correlation and then the other side shows that it
24 didn't control for that factor, and when you put the
25 controls in, it turns the result around.

1 The lesson is that U.S. Tobacco didn't put any
2 econometric response to the shoddy study that was done. If
3 they had, they could have blamed the damages away in a
4 district court.
5 I think we see time and time again that people do
6 super correlations, then the other side does some
7 sophisticated econometrics, perhaps just explained as
8 further variables, and they blow away the initial data.
9 MR. SCHEFFMAN: I said you won't find a
10 correlation or a regression in there at all. It is just
11 simple facts. Yes, here's the prices. Take a look at them,
12 see what you think. I'm not saying that is the only thing.
13 Economists can do more than that. If you do something other
14 than that, which you sometimes need to do, then you need to
15 be sophisticated about it, of course.
16 I was just responding that sometimes economists
17 can do something and they sometimes forget this, let's just
18 develop the basic facts here and see whether what the
19 lawyers are saying is true, and sometimes it is not because
20 often the business people don't have it right. That is
21 often where there is a big margin of opportunity. That is
22 not to say you can do any sort of modeling and correlation,
23 you better do it right.
24 MR. KNIGHT: In the minutes that we have left, I
25 want to give each of our panelists a chance to answer this

1 question and then to make any final points they wish to
2 make.
3 It has been suggested that perhaps the bar should
4 be raised on coordinated effects analysis, to bring it in
5 line with Sherman Act standards.
6 Does anyone see that developing, and if so, any
7 time soon? Again, make any final comments you may have.
8 MR. YDE: Because we have a short amount of time,
9 I am going to preface this by saying I think you have to
10 read the paper and then you will understand my comments, but
11 I think he has it exactly backwards.
12 I think effective coordination is not the standard
13 for drawing inferences in Section 1 cases, and effective
14 coordination is a standard in determining whether a merger
15 is likely to be anticompetitive or likely to violate Section
16 7.
17 I just disagree with the underlying premise and I
18 think it is exactly backwards.
19 MR. DICK: I think the standard is applied
20 appropriately or where it is applied is appropriate. You
21 have to prove that a merger will substantially lessen
22 competition. You have to establish there is a reasonable
23 likelihood that it will do that. Also, the lessening of
24 competition standard.
25 I think Jon was the one who quoted some of the

1 language from the Guidelines about the merger making
2 coordination more perfect, more complete, and more durable.
3 It doesn't say it is absolutely perfect or absolutely
4 complete or durable in all respects. It's a directional
5 implication.
6 MS. MAJORAS: I agree with Andrew. I think it is
7 more important that the various pieces that we use in
8 Section 7 analysis have some consistency as to the standard
9 that is used, as opposed to find consistency between a
10 Section 1 analysis and a coordinated effects analysis.
11 Just taking off on what Andrew just said, if you
12 contrast that with Section 1, when you are looking for an
13 agreement, one of the major differences is there, you are
14 looking backward. It has happened or it has not. What you
15 are doing is looking at circumstantial evidence usually, if
16 it has gotten this far, to decide whether in fact an
17 agreement has occurred.
18 Somebody knows the answer to that question, and
19 the purpose of the proceeding is to present evidence to find
20 this out.
21 When we are in Section 7 analysis, it is
22 completely forward looking, as Andrew says. That is a
23 difference. If you raise the bar, while it would make a lot
24 of our colleagues happy, truthfully, it would take it out of
25 kilter with the rest of Section 7, and in fact apply a

1 standard that I don't think was intended by Congress.
2 I agree it is an interesting paper and there are
3 times when you are working through a Section 1 problem and
4 you switch to a Section 7 one and that contrast becomes
5 quite clear and seems a little odd, but when you really step
6 back and look at it, it makes sense within the context of
7 the statutory framework.
8 MR. SALOP: I agree. A closing remark, what I
9 want to say in closing is that I think it is very important
10 that we economists not oversell what we are doing in
11 coordinated effects. The unilateral effects model goes back
12 100 years, it's a mainstream economic model. It might be
13 true that dead Chicagoans are held in higher esteem than
14 dead Frenchmen, but maybe not.
15 I think to some extent economists weren't cautious
16 enough in explaining limitations of unilateral effects to
17 the lawyers and policy makers to begin with, and the lawyers
18 understand it as, we believe you can predict the price
19 effect to three decimal points, and we were saying you don't
20 need lawyers, you can just run the regressions, and the
21 documents, depositions and so on don't matter.
22 I think with respect to coordinated effects, as we
23 make it more sophisticated, as we build coordinated effects
24 models and have empirical tests and so on, we need to make
25 it clear to policy makers that these are just little pieces

1 adding to the proof. This is not an attempt to replace what
2 we do now.
3 MR. SCHEFFMAN: I've done both Section 1 and
4 Section 7 cases. It's pretty obvious we have Section 1
5 standards for merger cases. I think we use the word
6 "collusion," but that is not really what we are doing at the
7 agencies. We are looking at substantial lessening of
8 competition, SLC, that the market is going to become less
9 competitive. Sometimes the way you say it, it is collusion,
10 you need to think as an economist, it is perfectly valid --
11 how we distinguish tacit coordination is that the unilateral
12 incentives are different. Unilateral incentives are quite
13 consistent with equilibrium.
14 I think this collusion thing is a red herring. We
15 really are just looking at is there a reason to believe
16 there is going to be less competition than there otherwise
17 would be. If you have a bona fide maverick, I don't think
18 it has anything to do with collusion. They are dragging the
19 price down lower than it ever was or would be. It's not
20 that they are going to start colluding after. I think that
21 is a red herring. It is not what we actually do. It isn't
22 fancy economics.
23 MR. KNIGHT: Jon Baker, again, you get the last
24 word.
25 MR. BAKER: I think what we need to do is find a

1 case where we have in front of us a set of facts and where
2 we can characterize it as coordinated or not. At the next
3 panel, that is what I will propose, the next time around.
4 I wonder whether merger analysis today would
5 differ if it were conducted entirely under Section 1. I
6 agree there was a difference when Section 7 was promulgated.
7 A lot has changed. It seems to me the Sherman Act and
8 Clayton Act are converging. And is Section 7 analysis very
9 different from Section 1 analysis at the end of the day.
10 MR. KNIGHT: On that note, I want to thank all of
11 our panelists for a tremendous job. Thank you all.
12 (Applause.)
13 **UNCOMMITTED ENTRY**
14 MR. GEBHARD: Let me begin by welcoming everybody
15 who has been hardy enough to stick around for this last
16 session of the day. Hopefully, you won't be disappointed.
17 My name is Ted Gebhard. I am an attorney in the
18 Policy Office in the Bureau of Competition here at the
19 Federal Trade Commission.
20 As the program indicates, the topic of this
21 session is uncommitted entry, a topic that is found at
22 Section 1.3 of the Guidelines.
23 As many of you know, the term "uncommitted entry,"
24 not the concept but the term, first appeared formally in the
25 Guidelines in the 1992 revisions. The concept of short run

1 supply substitution, however, is hardly new to antitrust
2 analysis. It has indeed a very long and distinguished
3 history.
4 Indeed, in the 1982 Guidelines the authors, in
5 attempting to provide a more rigorous algorithm for defining
6 markets and identifying market participants, spoke
7 specifically to the concept of supply substitution.
8 The 1992 Guidelines advanced this notion still
9 further and, in particular, articulated in a far more
10 precise manner the means by which the agencies will evaluate
11 entry in their merger analysis.
12 As I noted, the term "uncommitted entry" appeared
13 first in 1992 and, simultaneously, the term "committed
14 entry" appeared in the 1992 Guidelines.
15 Classifying entry into these particular categories of
16 committed and uncommitted suggests, at that time at any
17 rate, that it was thought that such a distinction would
18 improve the analytical framework of merger analysis, and
19 also hopefully the practical usefulness of the Guidelines.
20 We now have 12 years of hindsight and experience
21 by which to assess the efficacy of those revisions, and that
22 revision in particular. Among other things, we might ask
23 today, is whether classifying entry into these categories of
24 committed and uncommitted, and indeed, placing them at
25 somewhat in disparate parts of the Guidelines' overall

1 analytical framework has, in fact, helped or hindered the
2 usefulness of the Guidelines.
3 More fundamentally, given actual experience over
4 the past 12 years, we might ask whether it makes sense to
5 continue to try to draw this distinction.
6 From an economic standpoint, is it an artificial
7 distinction? Does it have a theoretical and/or practical
8 basis that is worth sustaining and maintaining for the
9 future? How often is uncommitted entry a key factor in
10 merger analysis and in what industries and markets might we
11 most expect the concept of uncommitted entry to play a
12 significant role in merger analysis?
13 To address these and other issues related to the
14 concept of uncommitted entry, I am pleased to say that we
15 have a very distinguished panel of commentators.
16 Let me just take a couple of minutes briefly to
17 introduce you to the panelists. To my far left is Doug
18 Melamed, who is a partner at Wilmer, Cutler & Pickering,
19 where he co-chair that law firm's antitrust practice group,
20 and as most of you know, in between stints in private
21 practice, Doug served as the principal Deputy Assistant
22 Attorney General at the Justice Department in the Antitrust
23 Division in the late 1990s, and culminated his tenure of
24 duty there as Acting Assistant Attorney General in charge of
25 the Antitrust Division.

1 Sitting next to Doug is Dr. Timothy Daniel, who is
2 an economist with NERA, here in Washington, D.C. Like Doug,
3 Tim also has a distinguished prior career in government
4 service, having served as an Assistant Director for
5 Antitrust here in the Bureau of Economics at the Federal
6 Trade Commission.
7 To my near right is Mark Whitener. Mark is
8 currently antitrust counsel for the General Electric
9 Company, where he has been since 1997. Like the others, he
10 also has prior government experience, for several years
11 serving as the Deputy Director in the Bureau of Competition
12 here at the Federal Trade Commission. Mark is also
13 currently an associate editor of the ABA's Antitrust
14 Section's Antitrust Magazine.
15 Last, but certainly not least, Dr. Rick
16 Warren-Boulton, a principal with MiCRA, an economist
17 consulting firm here in Washington. During his career,
18 likewise, he spent time with the government having served as
19 the Deputy Assistant Attorney General for Economic Analysis
20 at the Antitrust Division for several years in the 1980s.
21 With those brief introductions, let me ask Doug to
22 begin with some remarks on uncommitted entry.
23 MR. MELAMED: Thanks, Ted.
24 Obviously, issues of supply response and entry are
25 an important part of merger analysis, and indeed, lots of

1 aspects of antitrust analysis. I take it that the topic
2 today is not that broad one, but rather the narrower one of
3 the usefulness and desirability of breaking that topic into
4 two separate categories or dividing the universe of
5 potential entrants into two categories, so-called committed
6 and uncommitted entrants.
7 Under the Guidelines, which do make such a
8 distinction, uncommitted entrants are defined as firms that
9 are not presently selling in the market, but would enter
10 within one year in response to a price increase and could
11 enter without incurring significant costs.
12 Once found to be an uncommitted entrant, the firm
13 is included in the relevant market, and that, of course, has
14 implications for HHI and other calculations. Potential
15 entrants that are not uncommitted entrants are taken into
16 account, as Ted said, much later in the analysis as
17 described in the Guidelines.
18 In my view, the distinction does not enhance
19 merger analysis. It makes no sense for a number of reasons.
20 First, let me touch upon some of the reasons that are easier
21 to state.
22 There are practical problems with this kind of
23 distinction. It creates an additional issue in merger
24 analysis that some people may actually spend time on, and
25 that is worrying about what category does this potential

1 supply response fall into. This is not an area that is
2 likely to have or in my experience has had much pay off,
3 because there are almost always some costs, especially if
4 opportunity costs are taken into account. I guess this is
5 another way of saying that the fact that the firm is not
6 presently selling in the market says something. As I
7 understand it, there have been very few cases where
8 uncommitted entry has figured into the analysis.
9 Secondly, even where an uncommitted entrant is
10 identified, in reading the Guidelines, you can determine
11 that you haven't streamlined or shortened the analysis in
12 any way by making the identification.
13 The Guidelines are explicit about a proposition
14 that seems clearly correct. That is, even an uncommitted
15 entrant can't be deemed to be completely in the market.
16 That is to say that not all of its capacity should be deemed
17 to be in the market. The Guidelines state, for example,
18 that capacity that is "committed or profitably employed
19 outside the market," that it would not enter in response to
20 a SSNIP, and thus should not be included in the market.
21 Even if you identify an uncommitted entrant, you
22 then have to ask the question, how much of this entrant's
23 capacity should be in the market. And for that, you would
24 have to make the very same inquiry you would make about it
25 if it were a committed entrant. You have to ask, based on

1 the particular facts, what is the likelihood of the timing
2 and the magnitude of entry one might predict from this
3 entrant.
4 Not surprisingly, our experience doesn't suggest
5 there is any way this category streamlines the analysis, nor
6 does it affect the substantive analysis of the merger. It
7 might affect the substantive analysis if HHI calculations
8 were to be an end-all or even a hugely important part of
9 merger analysis. But we all know that HHIs are at best a
10 starting point.
11 The recent data released by the agencies suggest they are
12 kind of like starting point, they don't tell you an awful
13 lot about what is going to happen.
14 The uncommitted entry exercise is only apparently
15 to enable refinement of the calculations of the initial HHIs
16 and, it seems to me, that is not going to have much effect
17 on the outcome of the merger analysis.
18 In addition to those practical considerations, I
19 think there are theoretical problems with the
20 uncommitted/committed entry dichotomy. First, there is
21 always in my view a problem when you create categories and
22 force lawyers and economists to focus on the categories and
23 argue about whether something does or does not belong in a
24 category. You then begin to get a lot of reasoning by
25 analogy, rather than substantive analysis about what's the

1 competitive effects of the merger. At best, you have a kind
2 of undue formalism here by creating two categories from what
3 are really simply different places on a continuum.
4 Second, there is a real problem with calculation
5 of shares. If an uncommitted entrant is identified, you
6 have to figure out what does that mean. Is it going to sell
7 one widget or many widgets next year? You have to make a
8 judgment as to how much output should be put in the market.
9 Since the uncommitted entrant has no historic sales, the
10 only way you could possibly do that is by determining how
11 much of his capacity should go into the market.
12 We know from the Guidelines and sound analysis
13 that it is often the case that there are superior measures
14 to use for calculating market shares, such as dollar sales
15 and unit sales. If you try to put an uncommitted entry into
16 a market in which the Guidelines would ordinarily suggest
17 that the better way to calculate shares is by unit or dollar
18 sales, you either are going to have apples and oranges in
19 your calculation of market share, or you are going to be
20 requiring all shares to be calculated on the basis of
21 capacity, which will otherwise be regarded as the absolute
22 way of calculating shares.
23 The most important problem I have with the
24 distinction between uncommitted and committed entry is a
25 theoretical one. It doesn't, it seems to me, correlate very

1 well with its purported purpose. I take it the purpose is
2 to figure out what is in the market. I take it the purpose
3 of figuring out what is in the market is to be able to say
4 with more or less precision and accuracy what is the nature
5 of the competition in the market. What are the real
6 constraints on the competitive conduct in the pre-merger
7 period.
8 The reason you do that is to determine whether
9 this market is susceptible to anticompetitive restrictions.
10 If it was wheat farmers, we would probably think not. Or to
11 identify whether the merger seems to be eliminating what was
12 under the status quo ante an important constraint on
13 anticompetitive behavior by, for example, merging with a
14 maverick or merging with a company with a large market
15 share.
16 The uncommitted/committed entry distinction does
17 not tell you very precisely anything about the status quo
18 ante. The critical definition of "uncommitted entry" is
19 there are no sunk costs. Sunk costs are not an essential
20 condition for exerting a present competitive restraint.
21 Entry that takes a great deal of sunk costs could under some
22 circumstances induce enormous competitive constraints in the
23 market.
24 One industry, for example, is motion picture exhibition,
25 where a new state-of-the-art entrant in theaters could

1 overnight render obsolete the incumbents, because of a brand
2 loyalty in theater exhibition. By the same token, the
3 absence of sunk costs doesn't guarantee that there will be
4 an effect on present competition, because if limit pricing
5 is not required because incumbents could instantaneously
6 respond to anticipated new entry and retain their market
7 shares, then you are not going to have any present effect
8 from anyone who is characterized as an uncommitted entry.
9 For those practical and theoretical reasons, I
10 don't think the distinction makes any sense.
11 I think if we are going to have a distinction, I
12 would suggest we go back to some old fashioned nomenclature.
13 I would suggest that we ought to ask ourselves in assessing
14 the status quo: In addition to the firms in the market, are
15 there firms not in the market who are exerting a perceived
16 potential entry effect? Then you might be actually making
17 the state of competition in the market more competitive than
18 the status quo ante.
19 The second category, the committed entrants, those
20 who exert no present perceived entry or will predict actual
21 entries, and you analyze their impact on the merger, in the
22 competitive effects stage when asking the question, if there
23 were anticompetitive effects from this merger, would the
24 entry ameliorate them.
25 If you look at it in terms of a wings effect

1 rather than uncommitted entry notion, you might want to make
2 some rough judgments. How much of his capacity do people
3 think is likely to enter? What do they perceive to be his
4 likely entry? And you could calculate some HHIs in the
5 process calculation.
6 I don't know that it would become the HHI
7 calculation, but it would be a datapoint that might give you
8 some way of quantifying the magnitude of perceived potential
9 entry effect.
10 Beyond that, I would dispense with the kind of
11 dichotomy that the present Guidelines have.
12 MR. GEBHARD: Thank you, Doug. Tim?
13 MR. DANIEL: Good afternoon. I think my comments
14 are going to be largely complementary to Doug's. I'd like
15 to make a few additional points as we go. At the end, like
16 Doug did, I will have a practical suggestion for a possible
17 alternative to the current application of uncommitted entry
18 concept in the merger review process.
19 I don't think there is any disagreement among this
20 crowd that the Merger Guidelines provide a pretty logical
21 approach to the merger review, defining the market according
22 to consumer behavior, identifying participants in that
23 market, and then computing the shares and concentration
24 levels from the transaction, and then if you didn't clear
25 the concentration screen that triggers a more complete

1 analysis, you go into the competitive effects and the entry
2 and the efficiencies.
3 There is no disagreement that uncommitted entry as
4 defined in the Guidelines and as defined by Ted at the
5 outset of this session deserve a place at the table, and
6 needs to be considered certainly as part of the merger
7 review, and as a possible additive to an anticompetitive
8 effect.
9 The question is where uncommitted entry should be
10 analyzed. Ultimately, it really doesn't matter. I think
11 economists are all pretty much on the same page with regard
12 to that. You don't want to get hung up on where you do the
13 analysis, but certainly you do need to do it. The analysis
14 can be done in a confusing way and it can be done in an
15 efficient way, where it is done at the stage of identifying
16 market participants for purposes of calculating market
17 shares for those participants and the HHIs that follow.
18 Why do I say that? For many of the same reasons
19 that Doug just articulated, as laid out in the Guidelines.
20 It is relatively complicated. It's not enough just to
21 identify, as Doug would say, a firm that might be waiting in
22 the wings or as a firm that might have capacity and serve a
23 particular market.
24 I think to do the analysis correctly, you need to
25 assess the profitability of that uncommitted entrant's

1 beginning sales in the market of concern. To do that, as
2 the Guidelines point out, you need to consider the extent of
3 the uncommitted entrant's costs. I don't think there are
4 any cases where a firm that's not currently selling in a
5 market that decided to move into that market without
6 incurring any sunk costs, so the sunk costs are truly zero.
7 You have to consider the extent to which that firm would
8 incur those costs and the agencies have historically, and
9 rightfully so, been very concerned about trying to quantify
10 those and assess those.
11 In a differentiated products market, you need to
12 assess whether or not the uncommitted entrant would capture
13 sales. In other words, would its product be attractive
14 enough to consumers to make that entry matter to the
15 competitive equilibrium. It's not a simple analysis at all,
16 in my view.
17 Lastly, what economists like to do is assess the
18 profitability of entry to compare the margins that might be
19 earned by this uncommitted entrant going forward against the
20 sunk costs of entry and the ongoing costs of operations, and
21 see whether or not that uncommitted entry makes sense. In
22 my view, in those cases where the calculations of shares and
23 the calculations of HHIs and the calculations of deltas from
24 a merger are intended to be in an initial screen
25 -- is it time for us to go forward or not -- these kinds of

1 calculations are sort of outside that process and could be
2 an inefficient way to conduct the merger review.
3 This morning when I was here, I think it was Joe
4 Kattan who said something like entry analysis is the
5 analysis of last resort to a defendant, where they really
6 don't have any arguments to bring to the table. I'm not
7 quite as pessimistic as Joe about where to put that analysis
8 into the mix. I think in many markets, entry and exit are
9 happening all the time, and I think that analysis can shed a
10 ray of light on a merger review's process. My point here is
11 that I think that analysis needs to be done carefully. It
12 needs to be done in a detailed manner, it can't be done
13 terribly quickly. But in the end, I think the analysis is
14 one of profitability, the kind of stuff economists like to
15 do.
16 You would look at the sunk costs of entry. You
17 would look at the likely market share or sales that the
18 entrant could command on the marketplace, and then you would
19 see whether or not those profits are enough to clear the
20 sunk costs or upfront costs hurdle for that entry.
21 Doing that analysis requires getting the detailed
22 information from the firms in the marketplace, That
23 information would pertain to any firm that is not currently
24 selling in the marketplace, whether it be two, three, or six
25 months to the time that firm could sell so that it would

1 fall into the uncommitted entry box, or whether it be six,
2 12 or 19 months out and maybe be in the committed entry box.
3 It really doesn't change the importance of the analysis or
4 the nature of the analysis.
5 I don't think that distinction makes the merger
6 process move more smoothly.
7 To bring home the point, the Guidelines does the
8 analysis right in my view or directed us to do the analysis
9 right, but that analysis is complex. As I said, economists
10 like to do this stuff. This is not stuff that we propose
11 not to do. Certainly, I am not saying that at all. We are
12 supposed to do it at a different point in the merger review
13 process.
14 The first point speaks to the need to check and
15 see whether this uncommitted entrant will actually be able
16 to make sales in the marketplace. If a firm has the
17 technical capability to achieve such an uncommitted supply
18 response but likely would not, because of difficulties in
19 achieving product acceptance or distribution or production
20 would render such a response unprofitable, that firm will
21 not be considered to be a market participant.
22 I think the recent FTC investigation of the ice
23 cream case -- where the issue, as I understood it as an
24 outsider, was whether a new entrant, a new firm, could get
25 distribution of its ice cream products out to consumers --

1 proved to be a very lengthy undertaking, a very complicated
2 analysis in which the costs of distribution and the ability
3 to set up the distribution network were at the center of
4 that investigation.
5 Again, the kind of work economists love to do, but
6 it seemed to me to belong in the entry analysis as opposed
7 to the upfront analysis of assigning market shares and
8 computing HHIs.
9 On the second quote, it is to the opportunity
10 costs point that Doug mentioned, which is that in assessing
11 whether or not a firm is an uncommitted entrant under the
12 Guidelines, one would look toward the end of that quote,
13 whether the firm's capacity is elsewhere committed or
14 elsewhere so profitably employed that such capacity likely
15 would not be available to respond to an increase in price in
16 the market.
17 Again, this is an analysis that absolutely has to
18 be done, if you are proposing that a particular firm is a
19 potential entrant into a marketplace. You have to ask what
20 it is doing now and if that capacity is otherwise being
21 employed to serve another market, either another product
22 market or another geographic market. You absolutely need to
23 ask whether or not the profits in those markets would be so
24 high as to make entry into this particular market less
25 profitable and therefore not likely. This is absolutely

1 the analysis to do in the entry section of a merger review.
2 Let me leave you with just a very modest
3 recommendation, based on these views. I think on the
4 uncommitted entry analysis, as currently described in the
5 Guidelines, in other words, for what purposes of figuring
6 out who is in the market, who the market participants are,
7 what their shares are, could still be used, but in some
8 fairly limited circumstances.
9 Both of these conditions hold first if capacity is
10 the proper measure for calculating shares. This could be in
11 a homogeneous products market or in a market where consumers
12 make relatively large purchase decisions and therefore
13 capacity is only the right way to think about the ability to
14 serve these customers.
15 Capacity is the proper measure, as Doug mentioned.
16 Secondly, the capacity for an uncommitted entrant
17 is capacity that is controlled by a firm that is already
18 selling in the market at issue. Suppose we are talking
19 about glass containers generally and the specific market at
20 issue would be glass containers used for pickle relish, and
21 that is a defensible antitrust market on the demand side and
22 you are asking who is in that market from a market
23 participant perspective. Those firms that are currently
24 supplying that market with jars for spaghetti sauce and
25 gravy food and other products might also have capacity for

1 providing jars for pickle relish. If that capacity could
2 easily be swung for the supply and sale into the pickle
3 relish market, then I think it is absolutely appropriate to
4 consider that capacity in the jars for pickle relish market
5 at the outset of the analysis.
6 You would want to make sure that swinging that
7 capacity into a different end use segment would make sense.
8 That capacity is relatively easy to identify and I think the
9 calculations one would have to do would be relatively less
10 involved than turning to another firm that produces only
11 glass jars for wine, and then argue that firm could, with a
12 five percent price increase, be profitably selling into the
13 pickle relish market. That may well be true. You would
14 certainly want to entertain that as a hypothesis to test,
15 but to my eyes, that would belong in the entry analysis.
16 Let me just close with one important caveat, which
17 is that the remarks I make today in terms of laying out what
18 I think is an efficient way and an appropriate way to
19 implement uncommitted entry under the Guidelines analysis by
20 no means should hamper any arguments on what I am going to
21 take to a court.
22 There, you might very well include more than just
23 the limited supply response that I articulate here, for
24 purposes of calculating market shares, for purposes of
25 identifying market participants, because in the merger

1 review process, it is much more a back and forth between the
2 private parties and the government officials and the
3 investigative staff. In a court, you really need to sort of
4 lay out your best case at the outset, and if your best case
5 involves including those wine producers who you really think
6 can swing their capacity quickly into the direction of
7 pickle relish containers, that is exactly what you ought to
8 do, along with other supply responses that could be
9 available.
10 MR. GEBHARD: Thank you, Tim. By my reckoning,
11 the vote is now two to nothing in favor of the distinction
12 between committed and uncommitted entry being largely
13 artificial, with the possible exception of limited
14 circumstances that Tim mentioned at the end of his remarks.
15 I am wondering if there is anyone who will defend
16 this beast.
17 MR. WHITENER: Sure, why not. Let me find my
18 weapons here. I guess it falls to me to give the agencies
19 something to go on, if they want to keep this section in the
20 Guidelines, which I happen to think is a pretty good idea.
21 Let me begin by saying I didn't particularly seek
22 this work. I didn't have a particular ax to grind on the
23 section. I tend to agree with the other panelists, and I
24 think this is where Rick probably comes out, too, that it's
25 not a part of the analysis that gets used an awful lot, at

1 least not in the rigorous sense that it is laid out in the
2 Guidelines.
3 The question as I see it as a general matter of
4 Guidelines writing is if you have a good economic and
5 analytical framework, even if the analysis is a reasonable
6 approximation of what the agencies actually do, at least in
7 some cases, then you have a basis to pretty much leave it
8 alone. I think in this case the answer to both of those
9 questions is yes, and therefore the answer to the ultimate
10 question is yes.
11 There are a number of other aspects of the
12 Guidelines that I would probably have at before I would
13 touch this one. I'm sure others have talked about
14 unilateral effects plenty and will over the course of this
15 very helpful workshop. A very sensible framework until you
16 get into this enormously confusing mixing and matching of
17 market shares and market thresholds in an analysis
18 fundamentally not about shares and not about thresholds.
19 Let me see what I can do to present a fair and
20 balanced other side of this discussion.
21 Many people sitting in this room in some capacity
22 have had some role, in drafting the Guidelines. Obviously,
23 all of us try to work with them. I think there is a first
24 principle, which is don't mess it up. As I said, if you
25 have a framework that is economically sound, you should look

1 very closely at whether to start tinkering with it.
2 Actual enforcement does not go back to the sort of
3 stylized Guidelines analysis. Arguably now is a good time
4 to look at the HHI presumptions and see whether they really
5 are out of sync with what the agencies actually do.
6 Efficiencies were addressed in the 1990s to try to
7 expand our cursory analysis at the time. There are issues
8 not addressed in the current Guidelines, such as vertical
9 mergers, the third rail of antitrust. Some day, perhaps we
10 will see another attempt at that.
11 Another thing is just as a practical matter, when
12 you start down through the language, you create new common
13 law. You create new verbiage that has to be interpreted or
14 there is going to be a round of enforcement actions, and
15 only over a period of years can anyone even claim to
16 understand what the new Guidelines actually mean.
17 I suspect as we sit here today and yesterday we
18 have a lot of people who disagree about the Guidelines'
19 language that was written over 10 years ago means. That is
20 just a general and cautionary rule on re-opening the
21 Guidelines can of worms.
22 Finally, as a general introductory matter, if the
23 worse thing you can say about Guidelines is we don't use
24 them very much, I'm not sure that is a basis to re-open or
25 modify that part of the Guidelines. Let them sit there

1 dormant until some day somebody says, hey, I have a case
2 where swing capacity or repositioning or imports matter, and
3 I think it's helpful upfront to do some bit of assigning
4 them at least a presence in the market or imagine them being
5 in the market and see what that does for my competitive
6 effects analysis.
7 The sort of threshold question is is this part of
8 the Guidelines analytically and economically sound. I think
9 the answer is yes. I haven't heard disagreement with that
10 yet. We may still.
11 Doug and Tim raised some good points. One thing
12 that is very interesting is whether when you look at entry
13 and exit costs. We take account of the fact that exit costs
14 really are a cost of entry, in essence, or they affect the
15 entry decision. That is an interesting fact.
16 It has been pointed out that it may be that really
17 the pure uncommitted entry may have very little effect on
18 current pricing, because the incumbents may also be hit and
19 run pricers. They may not limit price because they figure
20 if the guy comes in, I will price accordingly, and if he
21 exits, I will price accordingly.
22 There are some interesting things to ask. It's
23 certainly not every case where entry might be quick, that
24 you are going to necessarily assign that firm a presence and
25 a share as if they were current market participants, for the

1 reason that Doug states. They may not have the current
2 constraining effect that a current market participant has.
3 Is it economically sound? I think so. I think
4 the critiques that we have heard so far focus on how often
5 is it applied. Is the distinction between committed and
6 uncommitted entry very often or ever a particularly useful
7 distinction to make. Are we engaging in market drawing that
8 is artificial.
9 I think there are some legitimate questions and it
10 might be interesting to look at exit costs and ask whether
11 hit and run entry is really what we are after in terms of
12 the price constraining effect. My sense is these are not
13 out of the mainstream of the fundamental Guidelines'
14 economics, so I think they pass that first test.
15 Are they ever useful as a practical matter?
16 Again, I agree with the sentiment that they are not useful
17 really very often. Most of us who have done a lot of
18 mergers have not very often sat down and created a market
19 participant and share table based in large part in
20 anticipated supply responses that have not actually been
21 demonstrated in the market.
22 There are a number of reasons why they simply
23 don't come into play very much. I don't want to spend a lot
24 of time on this. In coordinated interaction cases we are
25 really looking for who are the participants, how many are

1 there, what is the rough idea of their shares and their
2 significance.
3 As Doug points out, the shares are just a starting
4 point, so why go and do all this sometimes complicated
5 analysis to bring into that market those who have perhaps
6 the potential to come in quickly.
7 That is a fair point. The coordinated effects analysis is
8 in the Guidelines. It does look as a starting point at
9 shares, at least a number of firms. While I agree you are
10 not often going to come up with a very meaningful share
11 calculation for that supply response, that uncommitted
12 entry, you are at least going to sometimes get a sense of
13 how many credible players there are likely to serve
14 customers in the near future.
15 In a case where you have only two or three
16 incumbents after the merger indicating perhaps, assuming
17 entry barriers and all the other conditions, a very serious
18 issue, and you have three or four pretty approximate supply
19 responders, I don't know why you wouldn't say, that based on
20 kind of a quick analysis under the uncommitted entry
21 section, that you really have five, six, seven significant
22 players likely post-merger, in the event prices were to
23 justify a supply response, so you don't have a problem.
24 It might be a quick screen. Giving those
25 approximate supply responders their due, it may not be the

1 basis for a problem. If you defer them to entry analysis,
2 and I will come back to this, I think you will turn it into
3 sort of an undifferentiated well to do what. If we wouldn't
4 have a problem under the coordinated theory with five, six,
5 seven pretty comparably sized or decent sized firms, I don't
6 think we have to look much further.
7 Winding down point, again, fair enough. The lines
8 are drawn throughout the Guidelines. I don't think the line
9 drawing in this case is particularly severe. I think the
10 introduction of some costs in to the analysis in the early
11 1990s was a very appropriate analytically correct useful
12 addition to the Guidelines. What is significant in terms of
13 sunk costs? At least the Guidelines take a crack at
14 defining that, and talking about recovery of those costs.
15 You are not going to get out of line drawing if
16 you throw everything into entry. You are talking about two
17 years now, and indeed, I think you have somewhat less
18 guidance about what is sufficient entry under Section 3 than
19 you do under this section on how to evaluate the potential
20 presence of a firm as a current market participant.
21 Having said that this section is analytically
22 pretty correct and perhaps not useful very much, if it so
23 rarely is going to come into play, and is taking up space in
24 the document, you can make a case for saying let's keep the
25 document short and confined to those situations that really

1 come up in the real world.
2 I think there are some examples, but not too many
3 reported decisions that I think of really turned on an
4 uncommitted entry analysis. By the time you have a full
5 litigated case and looked at the entire marketplace and
6 competitive effects, one hopes, the role of those other
7 players has been fully evaluated. It almost doesn't matter
8 after a fully investigated and litigated case what category
9 you put them into.
10 We are talking here about enforcement decisions
11 and an analysis that lawyers can do going in and that the
12 agencies do in making the decisions that they make on a
13 weekly and monthly basis on which cases to bring and why.
14 In that context, there are some situations where I have seen
15 this analysis come into play.
16 One example is imports. Again, Doug and Tim would
17 probably agree that there are often going to be some costs
18 in virtually any kind of entry or repositioning. That is
19 obviously right. It doesn't mean they are significant.
20 They often will be some sunk costs. When we think about
21 product repositioning, that's probably the most evident,
22 creating brand or creating new feature sets in the
23 technology driven marketplace can be quite difficult in some
24 cases.
25 If you think of it in terms of imports, products

1 coming in from outside the geographic market, I think it is
2 a little easier to think of this as an useful analysis.
3 Importers may have relatively few costs of providing supply.
4 On the other hand, they may have significant costs and it
5 may not apply. In some instances, they may already have the
6 product. They have essentially the feature sets. They have
7 the expertise. Transportation costs may not be significant.
8 Why do we need this analysis to look at that? It
9 may be it's just as well in many cases to say let's look at
10 them as entrants and we will come to the same conclusion.
11 Again, I go back to the examples. Suppose you have decided
12 or you are considering a narrower geographic market. Say a
13 U.S. market. You think there is some basis for that, so you
14 have to take it credibly as an agency and ask yourself if
15 there is a problem in that market, and you only have a very
16 small number of local producers after the merger. If you
17 have the ability to approximate which firms with roughly
18 what kind of supply capability, measured as capacity or
19 likely sales, can be selling in that market in a reasonable
20 amount of time, why not at least count them in the sort of
21 estimation of current participants, and you might come to a
22 judgment that this is not a three to two deal, this is a
23 nine to eight deal, and therefore, we don't have to ask a
24 whole lot more.
25 You could go back and look at imports

1 historically. You could say, well, let's look at what has
2 happened in the past and let's look at shares over a 10-year
3 period, and on that basis, they are in the market. I think
4 that is just another way of doing what I just described.
5 The other example, and this is probably my main
6 point, another example of when this analysis can be useful,
7 probably less often than in the case of the imports or swing
8 production of a homogeneous product, but I put this in to
9 make a slightly different point.
10 The Guidelines do ask in unilateral effects cases, well, we
11 have found there is closeness, competitive proximity between
12 the merging firms for some group of customers. Now we have
13 to look at the supply responses. If essentially somebody
14 else who is adjacent to that differentiated segment could
15 readily reposition and come in, and that defeats the premise
16 of the unilateral effect.
17 The point here is that number one, the Guidelines
18 relate that back to the uncommitted or committed entry
19 analysis, depending on the nature of sunk costs. The
20 Guidelines today interlink unilateral effects and committed
21 and uncommitted entry in a way that I think makes perfectly
22 good sense.
23 The other point is my sense is there is a tendency
24 with the availability of transactional data to really
25 sometimes be enamoured of that competitive proximity, to

1 find that proximity based on data, and to be very interested
2 in looking at a potentially unilateral effects case based on
3 kind of static bidding data. Then to say maybe we have an
4 issue here, and really skip over or perhaps not give enough
5 credence to the repositioning point.
6 Go back to Joe Kattan's point. If entry is the
7 last resort, and I think, in fact, there is a lot of truth
8 in that, the last thing I think we should do is kind of
9 commit to uncommitted entry fringes the entry analysis,
10 because under unilateral effects maybe in many of these
11 cases will go away, even though the two merging firms are
12 close in some feature set or some regard, because there are
13 several other players today that have not chosen to sell in
14 that niche but could fairly readily do so.
15 We ought to look at them as supply responders and
16 not push them off as timely, likely, and sufficient entry.
17 To think of them as entrants is really straining the logic,
18 I think, at that point.
19 Don't mess with Guidelines if they are kind of
20 reasonably analytically correct and if they are sometimes
21 useful. I think they are reasonably analytically correct,
22 and I think they are sometimes useful.
23 Thank you.
24 MR. GEBHARD: Thank you, Mark. Exit polling now
25 tells us we have about a two to one vote. Let me turn the

1 podium over to Rick Warren-Boulton.
2 MR. WARREN-BOULTON: I'd like to do this standing
3 up. When we are criticizing the Guidelines, I want to see
4 if Werden is anywhere within range. It is easier to duck if
5 you are standing, if you are going to criticize them.
6 Since it's two to one, I'm going to change my
7 conclusion. I like the underdog, and maybe try to defend
8 the beast, perhaps for all the wrong reasons.
9 Going last means I am not supposed to repeat.
10 That's very difficult given that everybody else has done all
11 the good stuff. I have a friend that explains this by
12 saying if it's worth publishing once, it's worth publishing
13 two or three times. If it's worth saying once, it's
14 probably worth saying it two or three times.
15 I only have three points. My rule is never have
16 three of anything because nobody can remember more than
17 three of anything. I can't.
18 The first point I'd like to make is the true
19 uncommitted entrant, not necessarily the uncommitted entrant
20 of the Guidelines, but the true uncommitted entrant is like
21 an unicorn. It's a thing of beauty. It's often sighted.
22 It's hard to confirm. Everybody else seems to have seen
23 one. It's really hard to bag.
24 It's very difficult to get entry without some sunk
25 costs. The second and third points, I think, are more

1 interesting. Even if you find the illusive uncommitted
2 entrant, that's not likely to have much effect on the
3 analysis of a merger. Even if you bagged the unicorn, it's
4 not a particularly tasty thing.
5 The contrast, of course, is with the committed
6 entrant. The committed entrant is a real find, because when
7 you have a committed entrant, it is three to two, and now it
8 is two to two. We call this a two-two. Sorry. Took me a
9 long time to think of that.
10 SPEAKER: I can't wait for the third point.
11 (Laughter.)
12 MR. WARREN-BOULTON: If you find yourself one good
13 committed entrant, it is worth a very large number of
14 uncommitted entrants.
15 The third point is that finding a committed
16 entrant is going to have a significant effect on the
17 analysis. The real problem that I see that we are dealing
18 with here is the standard in the Guidelines for committed
19 entry is just too high. I don't want to use the word
20 "real." The point that I am going to make is in a world
21 with a great deal of uncertainty, even a very low
22 probability, even a highly unlikely probability of inducing
23 committed entry, can restrain prices and prevent what would
24 otherwise be a price increase after the merger. The point
25 is that the entry doesn't have to be particularly likely if

1 it's sufficiently dangerous.
2 Let's start with hunting the illusive unicorn. I
3 thank Tim Daniel for the unicorn analogy. As I understand
4 it, and I could be wrong, the defining characteristic of a
5 true uncommitted entrant is that even though it doesn't
6 actually make the product, sell the product at the moment,
7 its mere existence or presence out there, in the words of
8 the Guidelines, likely will influence the market pre-merger
9 and would influence it post-merger.
10 There are two ways that you might identify such a
11 creature. First, you can look for structural
12 characteristics that would imply this would be the case.
13 Then of course, although it is a little unfair, you could
14 actually look at the evidence and ask if it does behave that
15 way.
16 Let's look at the two of them. The first is the
17 one that lawyers love because you don't need any math to do
18 it, so what we are going to do is we are going to look for
19 evidence that the presence of the uncommitted entrant
20 actually effects prices currently, and therefore would also
21 affect them afterwards.
22 In theory, what the Guidelines do, because the
23 Guidelines are highly structural in this sense, is we say
24 that it should affect the current pricing decisions, if that
25 potential entrant, let's call it a potential entrant for the

1 moment because we don't know whether it's a committed or
2 uncommitted entrant, if it could cover any sunk costs before
3 the price raising of the incumbents after the merger and
4 could lower its price back down again. What we used to call
5 in the old days, before high tech hit, hit and run entry.
6 You can argue that those situations are going to
7 be unlikely and in fact, I think we all would. My favorite
8 example of why it is unlikely came in Staples, where one
9 Staples manager said, well, it's perfectly true that if
10 Office Depot came in and entered its local market, he would
11 really have to drop his prices by a very large amount, but
12 his best strategy was to make hay while the sun shined.
13 What he was saying is obviously the Office Depot
14 manager only cared about what his Staples' prices were going
15 to be after the Office Depot firm entered. If the Office
16 Depot firm did enter, the Staples guy would have plenty of
17 time to change all his prices. They could do that in 15
18 minutes. What the Staples' guy charged before Office Depot
19 entered wouldn't give any indication of how he was going to
20 price afterwards, therefore, higher prices pre-entry doesn't
21 of course induce any higher likelihood of entry. You might
22 as well price as high as you like because that is not going
23 to affect the probability of entry.
24 I think that is overwhelmingly the usual
25 situation. It's not always. It's possible sunk costs are

1 low enough and adjustment of incumbents is slow enough so
2 that you can get something that you might call hit-and-run-
3 after-a-little-while. That could be profitable and that
4 could constrain current prices.
5 The most likely candidates for that are in bidding
6 markets. The nice thing about bidding markets is an entrant
7 may be able to make sure he has enough business at an agreed
8 price to allow him to recover his sunk costs even before he
9 has to incur any of those costs. In that situation, he is
10 truly an uncommitted entrant.
11 Those are not the only situations. There are
12 situations in which a potential entrant could enter into
13 long term contracts with customers in the market. Airlines
14 are probably a good example. We all know it has been very
15 difficult for small firms to enter into the airlines markets
16 because of the price response of the incumbents. The
17 natural idea of the best way to do it is, that before you
18 enter, you go and you try to contract with customers.
19 Contract with large companies like General Motors who
20 promise to buy tickets on your airline if you enter, you can
21 contract with representatives of groups of customers. What
22 they will say is we will contract with you at prices that
23 are below current prices but above post-entry prices. We
24 will make sure you will survive. In those situations what
25 happens is the customers can make a committed entrant into

1 an uncommitted entrant and encourage entry.
2 I think the 1992 Guidelines, everyone agrees on
3 this, makes a contribution by focusing attention on sunk
4 costs, and I think that was presumably the purpose, but what
5 it doesn't do very well is it doesn't answer the other half
6 of the question. The first half of the question is how
7 large the sunk costs, but the second half of the question is
8 how long is it going to take the incumbent to react.
9 The thing that is really arbitrary in the sense of
10 the Guidelines is this one year to recover. If you are
11 going to ask this kind of question, what you should do is
12 you should ask how much are the sunk costs, how long would
13 it take to recover those sunk costs, and then compare that
14 with how long it is going to take the incumbent to adjust
15 his prices.
16 In other words, if it takes much less than one
17 year for an incumbent to adjust his prices, and in most
18 cases that is true, you can identify a whole bunch of people
19 as uncommitted entrants in the sense that you think they are
20 going to constrain current prices, when in fact they are
21 not.
22 What else could you look at? You could look at
23 actual evidence of competitive effects. When you start
24 walking down this road, the unicorn begins to look pretty
25 illusive. Think of the kinds of empirical tests that you

1 would want to run to see if a firm was an uncommitted
2 entrant.
3 Remember, the goal is does he currently constrain
4 prices, even though he is not actually producing the
5 products. You want to find evidence that prices or margins
6 are lower in markets where there are uncommitted entrants.
7 You want to find evidence that those margins fell when an
8 uncommitted entrant "entered as an uncommitted entrant," in
9 other words, wasn't actually producing in the market.
10 I know it sounds kind of funny. Let's imagine we
11 have an airline that starts flying between New York and L.A.
12 and between New York and San Francisco. What we want to ask
13 is what does this do to prices between San Francisco and
14 L.A. Do they fall? Do they fall as much as the prices fell
15 between New York and San Francisco. You are clearly now an
16 uncommitted entrant between San Francisco and New York, once
17 you are flying -- I'm sorry -- San Francisco and L.A., once
18 you are flying back and forth between San Francisco and New
19 York and New York and L.A.
20 A more interesting question is do you find
21 evidence of prices increased when the uncommitted entrant
22 entered the market, that is exited from being an uncommitted
23 entrant. One of my favorites is do you find evidence that
24 prices didn't fall when the uncommitted entrant began
25 actually producing the product. Shouldn't that be the case

1 if he's a true uncommitted entrant.
2 When you look at prices and margins, do you find
3 that HHIs that you have been calculating with assigning
4 shares of uncommitted entrants predict better than models
5 that don't assign shares of uncommitted entrants.
6 Even if you go through those exercises, you say,
7 okay, I found myself an uncommitted entrant, what you are
8 stuck with is the question of how large a share should you
9 give to an uncommitted entrant. I think the answer is the
10 only way you would give as large a share to an uncommitted
11 entrant as you would to a current producer would be once
12 again if you believed the actual entry of the uncommitted
13 entrant wouldn't have any effect on the prices.
14 That's a pretty tough test, which is why Tim
15 called this the unicorn story.
16 That was my first sort of argument. Then it gets
17 shorter. The second is parties try extremely hard to
18 characterize an entrant as uncommitted. Why? One of my
19 partners, Steve Solvenance, pointed out if you find an
20 uncommitted entrant, it isn't going to have much effect on a
21 merger, but as I said before, if you can find a nice
22 committed entrant, that's worth a whole bunch of uncommitted
23 entrants.
24 Essentially what you are saying with uncommitted
25 entry is you have to find a large enough number of them so

1 that you are going from a small number to that small number
2 minus 1, to from a large number to another large number.
3 That is not going to happen all that often.
4 I think Tim also commented, and I think correctly,
5 that what that means is uncommitted entry is likely to play
6 a larger role or be more useful in a Section 2 case than in
7 a merger case.
8 Finally, does all that mean that uncommitted entry
9 is just a concept, and well, it's not likely to do much
10 harm, it's not likely to do much good, so we might as well
11 leave it in the Guidelines.
12 I think the problem with uncommitted entry is it
13 really focuses attention away from committed entry. Steve
14 Smith in an article that came out right after the 1992
15 Guidelines made that point, that the really scary thing
16 about raising prices after a merger is it might induce entry
17 by someone who cannot easily exit. In other words, by a
18 committed entrant, somebody you are going to be stuck with a
19 long time and you can't get rid of.
20 The contrast with hit and run entry is that if
21 those hit and run entrants have no sunk costs, they are no
22 threat to incumbents. If you make a mistake with an
23 uncommitted entrant, you can always go back to the status
24 quo.
25 If there is a lot of uncertainty with respect to

1 the price that will induce entry, then if you run that
2 experiment and you get committed entry, there is a very high
3 price to pay.
4 Sort of like nuclear war here, the threat of entry
5 can really be an effective deterrent to a price increase,
6 even if that price increase would only slightly increase the
7 probability of entry.
8 The odd thing is it is perfectly possible in a
9 world of uncertainty, which I think is the world we live in,
10 committed entrant influences current prices more than a
11 uncommitted entrant.
12 If the Merger Guidelines makes a contribution here
13 or if the concept makes sense, I would like to say it is
14 because what you want to do is you want to make sure it is
15 only an uncommitted entrant. Where it separates out the
16 uncommitted and the committed entrants, and I think the
17 lesson we should learn from this is not that it is the
18 uncommitted entrants that are really very important, but it
19 is the committed ones.
20 The nice thing about the Guidelines procedure is
21 it lets you separate out the wheat from the chaff to get to
22 the guys who are really going to affect prices if entry
23 occurs, and those are the committed entrants.
24 Thanks.
25 MR. GEBHARD: Thank you, Rick. Now, all the votes

1 are cast, and by my reckoning, it is about 2.5 to 1.5.
2 (Laughter.)
3 MR. GEBHARD: I have just a couple of questions I
4 would like to throw out to the panel at large.
5 My sense is that much if not all of the discussion
6 that we have had this afternoon -- behind that discussion is
7 that we are worried about kind of an unilateral effects
8 analysis or story behind a proposed merger. We are worried
9 about whether the post-merger entity might be able to
10 exercise market power unilaterally.
11 I am wondering if the concept of uncommitted entry
12 introduces any particular complexities, any additional
13 complexities, or any peculiar complexities, that need to be
14 accounted for if we are talking about coordinated
15 interaction type stories, particularly one, a coordinated
16 interaction story that is not necessarily a collusion story.
17 What I had in mind here is if the uncommitted
18 entrant by definition is not already producing the product,
19 is not benefitting from any anticompetitive pricing that
20 might be coming about from the existing coordinated
21 interaction, if the merger is expected to perhaps increase
22 the degree of coordinated interaction and increase the
23 anticompetitive pricing.
24 What is the role of uncommitted entrants, and
25 let's suppose we have a factual situation in which we can

1 identify at least potentially uncommitted entrants, how
2 should that enter the analysis? Does that add any
3 particular complications?
4 MR. WARREN-BOULTON: Are you asking if an
5 uncommitted entrant could be more important than the current
6 entrant? I think that is what you are implying.
7 In that case, it would be yes, unless it was a pay
8 off. Having an uncommitted entrant would be more likely
9 than even just having one more firm actually in the market.
10 MR. GEBHARD: I take it then that doesn't add any
11 particular complications, as opposed to telling an
12 unilateral effects story.
13 MR. MELAMED: To the extent that the notion of
14 uncommitted entry had utility, I don't think there is a huge
15 difference between its utility in a coordinated effects and
16 its utility in a unilateral effects case.
17 If there is a waiting-in-the-wing's effect, which
18 is what I think might be useful in that kind of situation,
19 it certainly could constrain any anticompetitive behavior,
20 supercompetitive pricing theory.
21 In addition to that, one could imagine an
22 uncommitted entrant is actually colluding, if you have
23 multiple markets and the collusion takes the form of market
24 allocation.
25 MR. WHITENER: It's a very good question, an

1 interesting question. Unilateral effects, where I think the
2 importance is the greatest, the reason why Joe Kattan made
3 the comment this morning, low entry is I think the real
4 unicorn here, especially if we are talking about
5 differentiated products, which is where unilateral effects
6 usually arises. The folks who are potential suppliers are
7 almost always in some adjacent product area. It is a
8 question of repositioning, not a question of building a new
9 plant or coming up with new technology or investing 10 years
10 in intellectual property. I think it is certainly relevant
11 in some cases in those instances.
12 To your question, Ted, it seems to me that
13 identifying these in the wings or potential supply
14 responders in a case where the potential theory is
15 coordinated interaction, it could very well be they are
16 particularly significant. They may be the ultimate
17 maverick.
18 How does the market participant trying to evaluate
19 the payoffs from coordination evaluate the supply
20 responders? They may have as much difficulty evaluating the
21 timeliness, likelihood, degree of a potential uncommitted
22 entrant as the panelists here are saying the agencies would
23 have.
24 It seems to me it is an interesting question, and
25 it may be, I haven't thought about this a lot, that if you

1 had a number of those folks in the wings with the
2 capabilities to come in quickly, that may be a very
3 destabilizing factor for a coordination case. You would
4 need to look at that in as early in the analysis as you can.
5 MR. DANIEL: I would concur with Mark's view on
6 that. I think I would also concur with his entry point.
7 Committed entry to me really is the profitability
8 of the extension of that product line or extension of that
9 geographic region of the product.
10 With regard to coordination, I think any analysis
11 is going to learn early on, do we have a set of potential
12 suppliers here that are going to be destabilizing after the
13 transaction, if they are not selling now.
14 I haven't found much support for the argument
15 since I have been outside the FTC, that these are really
16 critical suppliers over the course of five years or for a
17 period of time, and had never sold the product in the
18 market, even though they may sell it elsewhere or something
19 similar.
20 I would take Mark's point from before, that if you
21 are looking at imports, you are really not going to get much
22 traction unless there are imports flowing into the market in
23 some point, in the recent past. To say there is a boat
24 nearby that has never stopped at a U.S. shore, even in the
25 last five years, it doesn't get me very far. I would be

1 hesitant to move forward very aggressively. I would think
2 about what it would take for him to begin doing what he
3 hasn't been doing before, which is serving U.S. customers.
4 MR. WARREN-BOULTON: One thing which I think is
5 worth noting, when people are looking for who is most likely
6 to be the entrant, and somebody who is making it somewhere
7 else, something like that, I think in many of the really
8 interesting cases, it's not somebody who is making the same
9 thing or making something similar, or making something in a
10 different area. It's a vertically related firm. If you
11 asked who was the most likely and the most threatening
12 entrant to Microsoft's desktop operating system, the answer
13 is Intel. The answer is if you have a monopoly in a
14 complementary product, that firm is not worried about price
15 reduction that happens after it enters because that firm can
16 pick it up. If the price of MS DOS had fallen, Intel could
17 pick it up by increasing the price of the chip.
18 There are these sort of really interesting
19 situations in which vertically related firms can and are
20 immune from the usual problem with entry, which is
21 post-entry price reductions.
22 MR. DANIEL: Moving to the third rail now, Rick.
23 Vertical mergers.
24 MR. WARREN-BOULTON: Yes, long overdue.
25 MR. GEBHARD: Rick may have already addressed this

1 question, at least in part, by noting that committed entry
2 is more important in terms of weight than uncommitted entry,
3 if you can make that distinction, and if you know of the
4 existence of a likely and timely committed entrant on the
5 horizon. Implicit in the concept of sunk costs is the cost
6 of exit. When we think of entry, often our instincts are
7 initially to think of costs of getting in. Perhaps to the
8 neglect of costs of getting out. By definition, are we not
9 worried in our merger analysis of costs of exit when we are
10 thinking in terms of committed entry. Hence, the name
11 "committed."
12 In light of the fact that if both are on the
13 horizon and we are relatively confident about a committed
14 entry story and an uncommitted entry story, and the rule is
15 to assign greater weight to the likelihood of committed
16 entry where cost of exit is if not unimportant at least less
17 important, than in the concept of uncommitted entry, is that
18 a basis for maintaining at least some distinction in the
19 Guidelines? Does that provide an analytical basis for
20 maintaining some distinction in the Guidelines?
21 MR. MELAMED: I don't think so. Why create two
22 separate categories? Rick says while an committed entry can
23 be a bigger threat because you can't get rid of them. That
24 could have a wings effect. That could have a huge
25 post-entry, post-merger ameliorating effect. In order to

1 understand that, you have to get beyond the categories and
2 you have to really ask how likely is this entry and how
3 likely is it perceived to be, how likely will it happen, and
4 over what time.
5 The category doesn't help the analysis. You have
6 to look at all the factors in the Guidelines, of which sunk
7 costs is one, and make an assessment.
8 I don't see why you go through the categorizing
9 exercise. I think you ought to just ask the question, is
10 there somebody that is not in the market now that might
11 ameliorate things and if so, how and to what extent.
12 MR. WHITENER: As part of the probably 1.5 votes
13 for keeping the test, I guess I would not point to the
14 difference in treatment of exit costs as the reason to keep
15 the analysis. I do think it is a relevant difference
16 between the analyses. I think the fact that even low entry
17 costs, they are likely to be low sunk costs of exit. It is
18 going to be legitimate to look at that type of player as
19 having a high elasticity of supply, someone you have to look
20 at as folks that potentially exert a constraint in the
21 marketplace.
22 I think probably what happens when we sort of
23 envision -- everybody has their own factor, sort of their
24 own way of thinking about mergers. I think in a lot of this
25 discussion, we tend to think about supply responders, in

1 heavy industry. I am making widgets but I could make
2 gidgets. That concept doesn't make a lot of sense often to
3 think about low sunk costs of entry. There are going to be
4 perhaps quite significant costs.
5 That is why I think the other examples that I
6 pointed to are probably more often where this is really
7 relevant, and imports is a good example to Tim's point. It
8 is not a good commentary on merger analysis if we are
9 automatically assuming that because the ships are sailing
10 past the ports, we are not going to count them.
11 We are supposed to do a dynamic analysis. We are
12 supposed to posit a change, either a price increase or the
13 entry analysis now talks about a supply increase or
14 decrease. There is an inducement for that ship to turn and
15 go into port.
16 If it is really that easy to turn and go to port,
17 analytically, we shouldn't care if it has never done that,
18 because before the merger, we have a nice competitive market
19 and afterwards we don't, it really ought to be what is the
20 actual dynamic effect, and if that is relatively easy, then
21 it seems to me we have a role for giving those folks some
22 degree of some presence in the marketplace, in our initial
23 cut of who the players are and what the analysis looks like.
24 MR. WHITENER: If there are price fluctuations
25 that seem to be the type that should draw the response and

1 it hasn't occurred, I agree. Maybe that is often going to
2 be the case. If you had a fairly stable seemingly
3 competitive market where the equilibrium does not give them
4 any reason to turn and go to port, and a merger arguably
5 changes that, then I guess it would be relevant to me
6 whether it's pretty easy to make a left turn and go hook up
7 to the dock and start unloading.
8 MR. WARREN-BOULTON: My concern is how we respond
9 to that. Even in this discussion, it's quite clear that
10 everybody is saying the merger is somehow less likely to
11 have a price impact if it never turned and went into the
12 port, if it really truly was an uncommitted entrant. If it
13 never turned and went into the port, there are some sunk
14 costs of entering and going into the port. If the
15 incumbents raise their prices, this guy is going to turn
16 into the port, and once he gets into the port, you are not
17 going to be able to get rid of him. The merger is likely to
18 be less of a problem if the guy never turns to go into the
19 port than if you see him routinely coming into port, and yet
20 the presupposition in every merger I have ever dealt with is
21 my God, do everything you can to see if you can characterize
22 that the guy is an uncommitted entrant.
23 MR. WHITENER: It is the interpretation that I
24 think I find really problematic, and I'm not sure quite how
25 that happened, except maybe it came earlier in the

1 Guidelines, and like all procedures, you spend all your time
2 worrying about what comes first.
3 MR. MELAMED: Analysis aside, if you are arguing
4 the world is going to hell but don't worry, there is going
5 to be a savior, you are in big trouble, and you want to
6 avoid being in that situation.
7 MR. GEBHARD: I see we have exhausted our time.
8 In fact, we have gone over for a few minutes.
9 Let me just close by noting that for a topic that
10 initially many people thought was not particularly the
11 sexiest on the workshop agenda, I think we have had very
12 interesting discussion, and some interesting comments this
13 afternoon.
14 For that, I want to thank each of the panelists
15 and thank the audience who stuck around for the late, late
16 part of the day.
17 Thank you very much.
18 (Applause.)
19 **(Whereupon, at 5:20 p.m., the**
20 **workshop was concluded.)**
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