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2 FEDERAL TRADE COMMISSION - DEPARTMENT OF JUSTICE

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4
5 HORIZONTAL MERGER GUIDELINES REVIEW PROJECT

6
7 Fourth in a Series of Five FTC/DOJ Workshops

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10
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12 9:00 a.m.

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15 Co-hosted by the Federal Trade Commission, U.S. Department
16 of Justice, and the Stanford Institute for Economic Policy
17 Research, Stanford University

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21 Stanford University
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FEDERAL TRADE COMMISSION

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P R O C E E D I N G S

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PANEL 1: DIRECT EVIDENCE OF COMPETITIVE EFFECTS:

MODERATOR: THOMAS ROSCH, COMMISSIONER, FEDERAL TRADE
COMMISSION

PANELISTS: JEREMY BULOW, Richard Stepp Professor of
Economics, Stanford University
KATHLEEN E. FOOTE, Senior Assistant Attorney
General, California Department of Justice
MARK A. LEMLEY, William H. Neukom Professor
of Law and Director, Stanford Program in Law,
Science and Technology, Stanford University;
Partner, Durie Tangri, LLP.
LAWRENCE WU, Senior Vice President, NERA
Economic Consulting

MR. ROSSTON: Good morning. I'm Greg Rosston.
I'm Deputy Director of the Stanford Institute for Economic
Policy Research, otherwise known as SIEPR. And we're happy
to have you all here.

SIEPR is a research institute at Stanford that
looks at all aspects of economic policy research, from
development to the California budget and the U.S. budget,
but also competition policy issues.

And so we're real happy to have the DOJ and FTC

1 here today to hold the workshop on Merger Guidelines. It
2 is, I think, quite fitting that it's held here at Stanford.

3 I first met Carl when we took an antitrust class.
4 He was visiting at the Center for Advanced Studies. And we
5 sat in on Bill Baxter's antitrust class to learn about
6 antitrust.

7 And given that Bill was so famously involved in
8 the Merger Guidelines, it's appropriate to have this back
9 here at Stanford. But I don't want to spend too much time
10 talking about things here, as opposed to letting you guys
11 hear the experts on this stuff. So I will turn it over to
12 Carl and Joe to tell you about the day.

13 PROFESSOR SHAPIRO: Well, let me also welcome you.
14 I'm Carl Shapiro, the Deputy Assistant Attorney General for
15 Economics in the Antitrust Division.

16 Joe Farrell, the Director of Bureau of Economics
17 at the FTC, is next to me and will speak in a moment. Since
18 Joe and I are both on leave as professors at Berkeley, we
19 thought it would only be fair to throw a bone to Stanford
20 and have this workshop held here.

21 (Laughter.)

22 PROFESSOR SHAPIRO: Well, I have to say, coming
23 from weeks of 20-degree weather in D.C., and coming down to
24 the campus here this morning it was extremely refreshing and
25 pleasant. And I felt like walking around the campus all day

1 long, but I will be here with you.

2 Let me just put today's workshop in context
3 briefly. We announced, the two Agencies together, that is,
4 announced in September that we'd be reviewing the Merger
5 Guidelines and possibly revising them. We got about 50
6 public comments filed by November, which is when we'd asked
7 for them by. Many very insightful, and we're appreciative
8 of that.

9 This is the fourth of five workshops that we're
10 holding. The remaining workshop is on January 26th in D.C.
11 at the Federal Trade Commission. And we have been getting
12 wonderful input from those workshops, the three that we have
13 held, and look for more of that today.

14 Internally at the same time we are reviewing our
15 own procedures, how merger investigations are conducted at
16 both Agencies, and setting that against what the Guidelines
17 say and what the Commentary from 2006 says, which is another
18 important document here because it provided a lot of
19 additional information about merger review.

20 And part of what we're looking at here is, if we
21 do revise the Guidelines, to what extent we can port in
22 material from the Commentary selectively, not -- the wide
23 Commentary, one of the things it does is through a number of
24 cases that are listed and put in the structure of the
25 Guidelines, the outline of the Guidelines.

1 We don't intend to do that, but there is a
2 Commentary around those cases that can be quite useful in
3 indicating things that are done at the Agencies that are not
4 so clear from the Guidelines themselves. So that's
5 something we'll look for the panelists today to perhaps
6 touch on, where elements of the Commentary can be useful in
7 the respective areas of the different panels.

8 Okay. So let me just turn it over to Joe. Thank
9 all of you in advance who are going to be participating or
10 for coming. Additionally, thanks Commissioner Rosch for
11 coming. He's going to be moderating the first panel, and
12 it's really wonderful that he's here to do that. We have
13 been very pleased to have a couple of the other
14 Commissioners, Pamela Jones Harbour and Bill Kovacic,
15 moderate other panels at other workshops; as well as the
16 likes of us, Joe and me and our ilk. So, Joe.

17 MR. FARRELL: Thanks, Carl. And thanks again to
18 Stanford and SIEPR for having us. Carl said most of what I
19 had to say. So let me just say a little bit more along one
20 of the lines that Carl already raised.

21 The Merger Guidelines Commentary was put out in
22 2006, which is very recently relative to the age of the
23 Horizontal Merger Guidelines themselves, which are now
24 practically an adult.

25 In my mind, at least, the goal of this project is

1 that people basically agree, I don't think there is much
2 doubt, that the fundamental issue in Horizontal Merger
3 review is will the merger harm consumers. And the process
4 is all about, well, what's the best way to investigate, find
5 out, and prove the answer to that.

6 So it's kind of an open-ended inquiry that is both
7 about economics and about process at the same time. In my
8 way of thinking, that's what we're here to discuss and try
9 to figure out, what's the best way to summarize or to
10 describe what is the best, and most useful, and also the
11 most used ways of analyzing that question. Thanks very
12 much.

13 So with that, we'd like to welcome the first
14 panel. As Carl mentioned, the first panel will be moderated
15 by Commissioner Tom Rosch. Thank you.

16 COMMISSIONER ROSCH: Let me introduce, first of
17 all, Mandy Reeves, who is my attorney advisor, and is a
18 wonderful helpmate on all of these projects, in particular
19 this one. And then the panelists, a very distinguished
20 group of folks, and I think we're all honored to have them
21 here.

22 On my far left is Jeremy Bulow, who's the Richards
23 Stepp Professor of Economics here at the Stanford Graduate
24 School of Business. Among his many accomplishments,
25 Professor Bulow served as Director of the FTC's Bureau of

1 Economics from 1998 to 2001.

2 Mark Lemley serves as the William H. Neukom
3 Professor of Law here at the Stanford Law School. He's also
4 a founder and partner at the firm of Durie Tangri, LLP.
5 Mark has previously testified before Congress, the FTC, and
6 the Antitrust Modernization Commission on issues of
7 antitrust and patent law.

8 Lawrence Wu is an old friend, as well as somebody
9 that I hired quite frequently as an economist when I was in
10 private practice. He's the Senior Vice President of NERA
11 Economic Consulting in San Francisco. He's submitted
12 analyses to the FTC, the Antitrust Division, and a variety
13 of international competition authorities. And prior to
14 joining the NERA, Lawrence served as a staff economist in
15 the FTC's Bureau of Economics and testified in a number of
16 FTC cases, including, I think, Poplar Bluff, as I recall.

17 Kathy Foote is another long-time friend and
18 erstwhile colleague at the McCutchen firm in San Francisco.
19 She's been a Deputy in the Attorney General's Antitrust
20 Section in San Francisco since 1988 and is currently the
21 Antitrust Chief. Prior to joining the state AG office she
22 served as Associate Dean at the University of San Francisco.

23 Let me make a couple of comments to sort of kick
24 this off and then I'm going to turn to the panelists,
25 because it's really their show and I want to learn from

1 them.

2 The first is that I am deeply engaged in this
3 project and, indeed, our office is. Right alongside Carl
4 and Joe, who were the sort of people who came up with this
5 idea of revising the Merger Guidelines, ever since that time
6 I have been very deeply interested in what we're all about.

7 And I think, number two, we can learn a lot from
8 what has happened with respect to prior panels on this
9 subject. And let me make about five major points based on
10 the testimony that we have heard to date from those prior
11 panels.

12 The first is that this panel arguably is misnamed.
13 It's a misnomer to call it a "direct effects" panel. Really
14 what we're talking about here is everything except the
15 structural case, which is currently upfront in the Merger
16 Guidelines, 1.0, if you are into numbers, that focuses on
17 market definition and concentration in the market.

18 What we're going to be discussing is everything
19 except that. But we will probably be discussing structural
20 to a certain extent, as well, because market definition and
21 concentration as has been noted in prior panels,
22 particularly by Professor Whinston; that is another way,
23 basically, of putting together a demand curve.

24 And certainly consumer demand is one of the
25 salient factors to be taken into account, not only in

1 unilateral effects analysis but, as he pointed out in a
2 prior panel, in coordinated effects analysis, as well. And
3 so for that reason, it is important that we retain to some
4 extent the demand-curve function in the Merger Guidelines,
5 because that's one of the things that people focus on.

6 Now another reason for retaining that in some form
7 or another at some point in the Merger Guidelines is that
8 the outside bar -- and this is very much inside baseball, by
9 the way. Merger law has its place in the West Coast, but
10 not nearly as much as it does in Washington, D.C.

11 That is what antitrust law is in Washington. It's
12 about mergers. And they cry out for certitude, for some
13 kind of safe harbor. And they think that that 1800 figure,
14 HHI figure, gives them that safe harbor. I kind of agree
15 with that and yet I disagree, because we have to, on the one
16 hand, balance the question of certitude, predictability that
17 the outside bar and their clients are crying for, against
18 fairness to the Agency, because we have to try these cases.

19 And frequently, if and to the extent that market
20 definition and market concentration are the be-all and end-
21 all of antitrust analysis, I think we're doing a disservice
22 to the outside bar, because that's not the way that the
23 agency staffs look at these matters at all, number one.

24 Number two, I don't think we can blind ourselves
25 to the fact that antitrust courts that are trying these

1 cases look to the Merger Guidelines as kind of an indication
2 of what the law is. And so if and to the extent that our
3 list of considerations starts and stops with market
4 concentration and market definition, we are being unfair to
5 the staffs of the agencies, as well, that have to try these
6 cases.

7 So it's a balancing act on the one hand between
8 predictability and certainty on the one hand, and on the
9 other hand factors that go beyond simply market definition
10 and market concentration. I will personally look forward to
11 what the panelists have to say about how to strike that
12 balance. It will be very interesting to me.

13 Third, the third lesson we learned is that we can
14 waste a lot of time talking about -- consummated mergers in
15 this panel, and we shouldn't. We shouldn't because, using
16 economics lingo, that's the ultimate in natural experiments.
17 You don't have to predict very much. You can take a look at
18 what has happened to prices, what has happened to other
19 factors as a result of the transaction. And so I kind of
20 wonder whether and to what extent we ought to treat
21 consummated mergers differently than unconsummated mergers,
22 even in the Merger Guidelines. There is less reason,
23 really, to spend a lot of time defining the relevant market
24 upfront, developing concentration ratios, et cetera, for
25 consummated mergers than there is for unconsummated mergers,

1 but we really have to make some kind of a prediction with
2 respect that, as Joe said and as Carl has said to me
3 privately, the ultimate question, which is what's the effect
4 on consumers. So I will look forward to that being
5 discussed by our panelists, as well. Finally, I kind of
6 wonder whether -- and this is kind of a segue, if you will
7 -- I kind of wonder if we haven't focused too narrowly on
8 consumer welfare, on the effect of a transaction on consumer
9 welfare.

10 We focused, in large measure, on price effects.
11 Number one, because that's the easiest measurement to make
12 and, number two, because we have been taught by the Chicago
13 School, as explicated by Professor Bork repeatedly, that
14 price effects are king. I don't think that that's
15 necessarily true.

16 It's well-recognized today that there are a number
17 of other aspects, dimensions, if you will, to consumer
18 welfare other than price. And one of those is innovation
19 and another one of those is quality. I like to think of it
20 as a continuum and, really, to take a look at what the
21 impact of the transaction is on consumer choice, which is
22 what I think it's all about.

23 And, again, I invite the panelists to talk about
24 what tools are available to us today for measuring factors
25 other than price and, particularly, factors such as consumer

1 choice. And so I'll look forward to that, as well.

2 Now the format that we plan to follow is as
3 follows. We're going to have remarks by each of the
4 panelists. Then we are going to have questions by each of
5 the panelists of the other panelists, and finally we will
6 turn to you. And that's not to say that you are the final,
7 that we're giving you short shrift, because we certainly
8 don't mean to do that.

9 And, to the contrary, I think you kind of put a
10 capstone on our discussion today. But, in any event, that's
11 what we plan to do. I don't plan to screen the questions.
12 So please try and not ask questions that read particularly
13 on your area of interest or on your clients' area of
14 interest, and try and broaden it out a little bit to discuss
15 some of these very salient matters that I have mentioned,
16 and others, as well.

17 I did mention Carl and Joe, to begin with. And
18 they certainly were the authors of this effort. But Greg
19 has been a good friend over the years, as well. He's been a
20 good friend particularly of my son, who's down in Silicon
21 Valley working here. And I have had the pleasure of coming
22 out to Stanford to talk to his classes from time to time.
23 So thank you very much, Greg.

24 And with that, I'm going to turn it on over. Why
25 don't we just start here? Lawrence, do you want to kick it

1 off?

2 PROFESSOR SHAPIRO: Before we do that, let's just
3 -- I don't think anyone's actually going to forget, but
4 there is a name tag here.

5 COMMISSIONER ROSCH: Okay.

6 (Pause in the proceedings at 9:32 a.m.)

7 MR. WU: Well, thank you for inviting me to speak
8 today. I wholeheartedly support the FTC and DOJ's efforts
9 to protect competition and consumers, and the Agencies'
10 efforts to develop an antitrust policy that reflects and
11 appreciates economic principles and analysis.

12 Now three things I want to say today. And that's
13 it, just three things. But three things that go straight to
14 organizing principles and three things that go to what it
15 takes to evaluate and develop compelling and credible direct
16 evidence of competitive effects in merger cases.

17 So here's the first thing, which I will put in the
18 form of a question. When we think about evaluating evidence
19 on competitive effects, what should we focus on?

20 My answer here is that our unified principle ought
21 to be based on increasing consumer surplus or preventing a
22 loss of consumer surplus. And that means looking at price
23 effects, but it also means looking at output effects and
24 innovation. It's natural to look at price effects as a
25 proxy for consumer surplus. Consumer surplus falls when

1 prices rise, all else equal. Plus price is a natural way of
2 integrating the efficiencies analysis.

3 So a merger of two close competitors could lead to
4 higher prices, but with efficiencies prices could fall.
5 What tends to get short shrift, though, are output effects
6 and innovation. But if our unifying principle is consumer
7 surplus we can avoid that problem.

8 So, in general, an increase in total market output
9 will correspond to an increase in consumer welfare.
10 Innovation is just as important. As my colleague, Greg
11 Leonard, and I pointed out in our comment to the Agencies,
12 these output enhancing efficiencies should not be ignored,
13 especially in light of the substantial and increasing
14 importance of innovation in the U.S. economy.

15 By focusing on consumer surplus as our guiding
16 principle, we can capture all of these key elements.

17 So here's topic number two, again, in the form of
18 a question. When we think about quantifying the competitive
19 effects of a merger, what is an appropriate organizing
20 principle?

21 Well, my answer here is that we need a framework
22 that asks whether consumers are better off with a
23 transaction or whether they are better off without a
24 transaction. And that means we need to think hard about
25 counterfactuals, and we need to get evidence that describes

1 how the market would look with the transaction and how the
2 market would look without the transaction.

3 Now this is already part of the Guidelines. In
4 considering efficiencies one question is whether
5 efficiencies could be achieved without the merger. And that
6 means we think hard about what would happen if the
7 transaction did not take place. And in evaluating the
8 possibility that the firm to be acquired may be failing,
9 will you do the same thing. We ask and think about whether
10 the firm would be viable without the transaction. But why
11 not extend the concept of the counterfactual to encompass
12 how we think about competitive effects generally instead of
13 thinking about competitive effects, entry, and efficiencies
14 as separate and distinct steps? Why don't we think about it
15 as an integrated whole?

16 And if we formalize the analysis this way, I think
17 we have a better shot at performing the integrated approach
18 to merger review that is described in the Agencies' 2006
19 Commentary on the Horizontal Merger Guidelines.

20 Now the need to describe the postmerger world also
21 affects the kinds of analysis we do. As an example, suppose
22 we want to estimate the effect of a merger by comparing
23 prices in two types of markets: Markets in which the
24 merging firms have stores and markets in which only one firm
25 is present.

1 If there is a price difference, is this the merger
2 effect? Well, it might be because the price differential is
3 an estimate of the price change that would occur if the
4 stores to be acquired were no longer present as competitors.
5 For the premerger markets in which only one firm's stores
6 were present may or may not be the right counterfactual;
7 that is, what the market would look like postmerger.
8 Suppose the merging firms were to close the stores of firms
9 that they acquired? Well, if that's the counterfactual,
10 then the analysis that I just described might fit. However,
11 if the acquired firm's stores are going to remain open, then
12 the analysis may or may not be as relevant.

13 Again, it goes to: What is the right description
14 of the postmerger world. The need to think about the right
15 counterfactual also sheds light on why we need to do a
16 relevant market analysis. Now I don't mean a relevant
17 market analysis that's done for the purpose of computing
18 shares and concentration.

19 But I am referring to a relevant market analysis
20 that identifies the supply and demand portions that
21 determine price. So let me just give you a couple examples.
22 So suppose we want to test empirically the hypothesis that
23 an increase in concentration is likely to lead to higher
24 prices.

25 To do that we might look at a cross-section or a

1 panel of markets over time. This is a conventional price
2 concentration study. But let's not take things for granted.
3 To do this analysis properly, we do need to think about what
4 it is we are studying.

5 Should we think about prices over a cross-section
6 of metropolitan statistical areas? Should we look at how
7 prices vary across counties? What products or prices are we
8 actually going to look at?

9 Well, a price concentration analysis is an
10 analysis of markets, which means that before we can even do
11 the analysis we need to go through the analytical steps that
12 are similar to what we do in market definition.

13 The need for a good counterfactual also comes into
14 play when assessing the prices effects of a consummated
15 merger. So, for example, you may have data on the price
16 change that occurred postmerger, but what's the benchmark?
17 Identifying the firms, the products, and prices that you
18 would use to determine whether the merged firms raised its
19 prices above competitive levels is part of a relevant market
20 analysis.

21 So if we have, as one as our principles, the need
22 to fully describe both the premerger world and the
23 postmerger world, then we have a coherent and integrated way
24 to think about not only efficiencies in failing firms, but a
25 disciplined framework that we can use to evaluate how and in

1 what way a transaction will change the process of
2 competition to the benefit or detriment of consumers. And
3 the framework would also help us interpret the economic
4 evidence more appropriately.

5 Okay. Here's my third topic, again, expressed in
6 the form of a question. What makes for a compelling and
7 credible analysis of competitive effects? This is the key
8 to making the right decisions in the merger review process
9 and the key to developing a compelling argument in court.

10 The virtue of direct empirical evidence is based
11 upon data that are likely to be specific to the market,
12 markets at issue. So what types of analyses might we
13 consider doing? Well, the list is a familiar one. So I
14 won't spend much time going through the list.

15 There are bidding studies. There are natural
16 experiments. For example, the question here might be: Was
17 there a price reaction following the entry of a competitor?
18 There are also studies that we can do to evaluate key
19 propositions, like the relationship between price and
20 concentration.

21 Well, these variables tell us that we need certain
22 things to do these types of analyses properly. We need
23 relevant and reliable data, and we also need a circumstance
24 that make these studies possible, like numerous local
25 markets with different types of concentrations and shares,

1 previous mergers, bidding situations, new additions of
2 capacity, and the like.

3 And why are these analyses compelling? They're
4 compelling because for the most part these are analyses that
5 do not require some difficult-to-prove assumption about the
6 demand curve or some underlying model of competition, and
7 they don't depend on some untested proposition about pricing
8 and concentration.

9 The second reason is that most of these analyses
10 can be subject to scientific scrutiny, which means they can
11 be replicated and tested. But why might an empirical
12 analysis of this sort I just described not be compelling or
13 credible? Well, one problem is that not all natural
14 experiments are analogous to a merger.

15 So if we observe, for example, that prices in a
16 market did not rise after the exit of a competitor, should
17 we infer that a merger of two competitors in that same
18 market also would not lead to higher prices? Maybe, but
19 maybe not. It depends on whether the firm that left the
20 market is similar at all to the firm being acquired. And
21 that's a fact that could affect the credibility of the
22 analysis.

23 Second, the credibility of an empirical analysis
24 may be called into question if it is inconsistent with other
25 evidence. So, for example, what do you do if you have

1 direct evidence of effects, but customers are not
2 complaining? Well, first, you have got to make sure you did
3 the analysis right.

4 And if the analysis is done right, it's time to
5 think about the customers who are not complaining and why
6 they might not be complaining. What are their incentives?
7 Are they credible? Could it be that the testimony is from
8 large customers who are able to protect themselves, but not
9 from small customers who cannot?

10 It's important to understand what factors affect
11 the credibility of analysis on direct evidence because, if
12 we're going to rely on direct evidence, we need to make sure
13 that the analyses are relevant and done right. But on top
14 of that, if there is contradictory or conflicting evidence,
15 we're going to have to make decisions about what pieces of
16 evidence we are going to rely on and which pieces of
17 evidence that we might give less weight to.

18 So, for example, again, if we have customers who
19 are not complaining, but we have direct evidence of effects,
20 what are we going to do? Well, decision theory would say
21 that we should give more weight to the pieces of evidence
22 that are more precise or reliable. And this is likely to
23 vary from case to case. So I'm not sure we would say one
24 piece of evidence is always better than another.

25 Second, there is the practical issue of going to

1 court. And I'll leave it to others in this room whether or
2 not the Agencies can go to court and win with direct
3 evidence, but no complaining testimony of witnesses.

4 So here are my conclusions. I think the Merger
5 Guidelines should reflect Agency practice for being
6 forwardlooking. Let's first define what Agency practice
7 ought to be and provide the Guidelines accordingly so that
8 the Guidelines will be in sync with Agency practice.

9 And what are some of these desired Agency
10 practices? Well, first, I would focus the competitive
11 effects analysis around the concept of consumer surplus,
12 which means that we look at output and innovation, as well
13 as price.

14 Second, I would have as one of our organizing
15 principles, the need to clearly describe a premerger and
16 postmerger worlds.

17 That would include a good description of what the
18 parties plan to do postmerger, how their incentives may
19 change, and the likely competitor responses. If we do that,
20 then we have a coherent and integrated way to think about
21 competitive effects, entry, and efficiencies at the same
22 time.

23 And third, as Agencies now develop compelling and
24 credible evidence of competitive effects, it is not easy and
25 there are no shortcuts. The overriding Guidelines that

1 describe that encourages a gathering and testing of all
2 types of direct evidence is a step in the right direction.

3 COMMISSIONER ROSCH: Let's hold the questions
4 until or the comments about each speakers' presentation
5 until the end.

6 Mark, you want to go ahead?

7 PROFESSOR LEMLEY: I have got somebody's watch
8 here.

9 MR. WU: I got it.

10 COMMISSIONER ROSCH: Okay. Well, then you are way
11 ahead of the game.

12 (Laughter.)

13 COMMISSIONER ROSCH: Yes. Okay. Got it.

14 PROFESSOR LEMLEY: All right. Good morning.

15 What I want to suggest today is that our market
16 definition is broken, not in the sense that we're not doing
17 it right, but that the entire enterprise is not likely to be
18 helpful in the modern economy.

19 Market definition is a binary yes/no question in
20 an analog world. It is something that works conceptually in
21 a world in which markets are static, they don't change over
22 time, in which products are homogeneous and in which
23 consumers are homogeneous. If anybody actually encounters a
24 market which doesn't change over time, all the consumers are
25 homogeneous and all the products are homogeneous, well,

1 then, I think you can reasonably apply the market definition
2 test there.

3 Now in the real world, of course, none of those
4 things turns out to be true in a wide variety of
5 circumstances, and more particularly, I think, in the set of
6 circumstances in which we're actually likely to see mergers
7 that are of potential antitrust significance.

8 All right. Certainly, in the kinds of things we
9 see in Silicon Valley, but even across a wider range of
10 industry we have got to worry about a variety of more
11 complex circumstances.

12 Now one thing you can do, one thing the current
13 Guidelines do to try to get at this homogeneity problem is
14 to try to make a lot of it irrelevant using the SSNIP test.

15 So maybe even if we have a variety of different
16 consumers with different viewpoints, even a variety of
17 different producers with different cost structures, if we're
18 confident that x percentage of them will not be able to
19 respond to a change in price, will be forced to pay the
20 higher price, or will not enter in response to a change in
21 price, maybe we could say, right, we are therefore
22 comfortable that this merger has at least some problems and
23 so we can ignore the heterogeneity in the rest.

24 The problem, though, is that even applying that
25 SSNIP test in the context of a traditional market definition

1 is going to miss the point in a large range of cases, unless
2 we do a bunch of modifications to it.

3 First off, of course, it runs right into the
4 *Cellophane* fallacy.

5 You can define a market, right, and if a company
6 is, in fact, operating as a monopolist and pricing
7 effectively, are market definitions going to lead us, as it
8 did the Court in the *Cellophane* case, to wrongly understand
9 the competitive pressures that company faces?

10 Second, it assumes static pricing. It assumes
11 that prices either stay the same in a normal, nonperturbed
12 setting or increase slightly in accordance with inflation.
13 If you are in a market in which prices normally drop
14 significantly over time, if you sell semiconductor chips,
15 for example, right, the question of whether someone could,
16 in fact, engage in a small but significant, nontransitory
17 increase in price as a result of a merger is unlikely to be
18 helpful.

19 A real question might be: Would they be able to
20 drop the price less over time than they otherwise would in
21 response to technological innovation? But that's a much
22 harder question to ask. It ignores nonprice competition,
23 something Lawrence Wu's already talked about, but which
24 again in a large chunk of markets is, if anything, more
25 important than price competition.

1 If you gave a set of consumers the choice between
2 a really competitively priced Sony Walkman from the 1980s or
3 an iPod, I bet they'd take the iPod, right, even if this is
4 not competitively priced, but because the competition that
5 goes on in the market is not just price competition. Of
6 course, it's innovation competition. It's nonprice
7 competition.

8 Price discrimination, I think, is a further
9 problem, right. If we are going to set our market
10 definition on the basis of price response, the fact that
11 companies can differentially price because they have
12 differentiated products or because they have differentiated
13 consumers means that the signal we are going to get from
14 market definition and traditional structure analyses is
15 wrong.

16 And then, of course, there are markets in which
17 the payment decision and the purchasing decision are
18 disconnected, right. So all of the pharmaceutical and the
19 healthcare industry, in effect, is skewed in the market
20 definition since by the facts that the people who are making
21 the purchasing decisions are not the ones who are actually
22 paying the bills. That makes it extraordinarily difficult
23 to get meaningful data on market definition analysis on even
24 seemingly simple questions like does a brand-owning
25 pharmaceutical company compete with a generic company

1 manufacturing precisely the same drug but selling it at a
2 substantially lower price?

3 Now none of these problems are unsolvable, right?
4 What I want to suggest, though, is that if we are solving
5 these problems we are doing it by essentially abandoning the
6 market definition inquiry.

7 If we can accurately define a market subject to
8 the constraints I have just talked about, we don't need to
9 define the market, because what we have done is actually get
10 more directly at the question of consumer demand and
11 producer supply, get more directly at the question of market
12 power and of likely competitive effects.

13 It's then kind of bizarre to say, well, we are
14 going to take all of this rich data that we have had to
15 collect to make sure that we get it right and then put it
16 into a static structural analysis that gives us an HHI
17 number, and take that HHI number and then feed it back into
18 a model of whether or not people would, in fact, behave in a
19 particular way, right.

20 You are likely to lose relevant information; you
21 are likely to increase your number of false positives if,
22 instead of taking the information that you have to collect
23 to accurately assess competitive effects, and just asking
24 the question: Are there competitive effects, you take that
25 information, feed it into market definition and feed it

1 back.

2 So all of this leads me to believe that we ought
3 to be paying more attention than we do to evidence of direct
4 effects and less attention than we do to evidence of the
5 kind of traditional structural analysis that has informed
6 the market guidelines.

7 Where can we get that evidence? Well, this is a
8 hard problem. It's an easier problem in some sense in
9 monopolization cases than it is in merger cases, because of
10 what Commissioner Rosch suggested, which is don't tell us
11 about what to do about consummated mergers; those are in
12 some sense the easy ones or tell us what to do about mergers
13 that haven't happened yet, right.

14 And in mergers that haven't happened yet the
15 problem, of course, is we don't yet have direct effects of
16 many of the kinds of evidence that we are interested in,
17 because we haven't actually seen the change. Nonetheless, I
18 think you can actually gather a variety of types of evidence
19 that may be of significance.

20 First off, it seems to me that companies actually,
21 in most circumstances, have a pretty good idea who their
22 competitors are. So one of the things you want to know is
23 not just what does a market definition analysis tell you
24 about whether company A or company B compete, but how does
25 the behavior of those two companies help us to answer the

1 question of whether or not they compete, right.

2 Do they talk about each other internally as
3 competitors? Do they engage in advertising against each
4 other? Do they engage in intellectual property litigation
5 against each other? Do they make their own pricing
6 decisions with respect to each other? Do they make entry
7 decisions with respect to each other?

8 Similarly, I think you can draw inferences about
9 likely market entry from a company's behavior. The company
10 has a sense of whether or not if they engage in a particular
11 type of conduct it will draw entry. And companies who
12 engage in things that sacrifice profits in order to achieve
13 long-run change in the competitive dynamic likely are doing
14 so because they have made an assessment, either explicit or
15 implicit, about the likelihood of entry that is going to
16 undermine that tactic.

17 And then, of course, we can look, as Lawrence
18 suggested, in some circumstances, at natural tests, at other
19 analogous markets, at the effect of past analogous mergers
20 on competition.

21 All of this is imperfect evidence. But what I
22 want to suggest here is that all advantages are comparative,
23 and that the right weight is not the imperfections of direct
24 evidence against the perfections of an idealized structural
25 model.

1 The right weighting is the imperfections of direct
2 evidence against not only the messy world of real market
3 definition, but a world in which, if we are to get market
4 definition right, it's going to be in part by looking at
5 those very direct effects. If we are looking at them we may
6 as well think about them directly.

7 Now we then come to what I think is the hardest
8 problem, which is the certainty problem. There are a lot of
9 mergers out there and there are a lot of mergers out there
10 that probably don't deserve antitrust challenge.

11 An antitrust scrutiny that involves inquiring into
12 all of these effects is a fairly robust antitrust scrutiny.
13 It's something that I think certainly ought to play a
14 greater role in actual merger challenges.

15 Once the Commission or the Justice Department has
16 made a decision to challenge a merger, to devote substantial
17 resources to the case, it seems to me quite logical to think
18 that we ought to be paying more attention in the analysis of
19 the merger itself to the direct effects and not to the
20 structure and HHI concentration.

21 But what do you do about the big swath of cases in
22 which the question is: Should I bother to even go to second
23 request? All right. How can we devote our resources
24 efficiently to figuring out which mergers to challenge and
25 which ones not to?

1 And I guess, you know, I don't have a great answer
2 to this question, except to suggest that we don't fully
3 appreciate right now the extent to which we are stumbling
4 across the same problem, even in the current Hart-Scott-
5 Rodino environment.

6 If we are doing an HHI analysis in any
7 Hart-Scott-Rodino review case, we are either doing this
8 inquiry implicitly anyway, or we are engaging in this very
9 stylized, static model of what it is that the market
10 consists of that is likely to get it wrong.

11 So the question I think becomes the extent to
12 which we are willing to trade off effort and some analytic
13 uncertainty to try to get a better result, but I think that
14 question has to be considered bearing in mind that the
15 certainty that HHIs offer us is an illusion.

16 Plaintiffs and defendants in any merger case can
17 and do come up with market definitions that give us totally
18 different HHIs. So the argument that the antitrust bar
19 makes that says, well, we have got to have our HHI safe
20 harbors, because otherwise we won't know what to do, I think
21 just misses the point.

22 You don't have an HHI safe harbor. What you have
23 is an ability to argue that the market is defined in such a
24 way that your HHI is sufficiently low that the government
25 should not challenge the merger. But if all you've got is

1 the ability to argue that, that shouldn't give you any more
2 certainty than the ability to argue that the direct effects
3 of the merger are not likely to be anticompetitive.

4 We should certainly strive to specify as much as
5 possible the evidence that the Agencies will and want to use
6 in helping to evaluate these things, but I don't think we
7 should rely on a false certainty in the HHI analysis to
8 assume that mergers will become more problematic or more
9 uncertain in a world that doesn't use it.

10 The final point, and then I'll stop, is the
11 question of the extent to which some sort of structural
12 market definition analysis is required in antitrust law.
13 When we get to court at the end of the day, does the law
14 require us to do HHI analysis? Now, stated at that level the
15 answer is no.

16 There is no requirement in the law that mergers
17 have particular HHIs. There is, however, a statement in the
18 statute that requires that mergers tend to concentrate or
19 strive towards monopoly in a line of commerce, in any line
20 of commerce. You could interpret that, I think, in one of
21 several ways.

22 But at least one plausible way to interpret it is
23 that it does require that there be a business that the
24 merger tends to monopolize or at least restricts competition
25 in, maybe that requires some sort of market definition.

1 To me it seems that what it really requires is a
2 market-power analysis, but that market-power analysis
3 doesn't have to be linked to a structurally-defined market:
4 Here are the boundaries of the market; you are either in it
5 or you are outside it.

6 But if it did, if a court ultimately said, gosh,
7 we have been doing that since *Philadelphia National Bank* and
8 we have got to continue doing it that way, then it seems to
9 me that the right workaround is not to base our entire
10 analysis of whether to challenge a merger on the question of
11 where that line is, but to back into it, to figure out the
12 market-power analysis, figure out the direct effects, and
13 those things are going to tell us, more effectively and more
14 accurately than a pure structural analysis, what the right
15 market definition is. Thanks.

16 COMMISSIONER ROSCH: Let me violate my own order
17 here, because you've raised so many issues.

18 First of all, I see Karen Silverman sitting out
19 there, and I know that she counsels clients on mergers all
20 the time. And certitude is certainly part of that analysis,
21 but I've got to tell you that when I was doing it I always
22 told a client that while the HHIs were important, they were
23 just one factor.

24 And by far the most important factor was what is
25 the storyline of the transaction? Is it procompetitive, is

1 it anticompetitive, or is it competitively benign?

2 And, frankly, the reason I felt that way was for
3 precisely the reasons that Mark has described, as well.

4 I considered the market definition and structure
5 analysis that was in Section 1.0 to be -- it was kind of an
6 artificial certitude, but I leave that to you guys to hash
7 out.

8 Go ahead, then, Kathy.

9 MS. FOOTE: Thank you. It's great to be an
10 academic. As a government employee, however, I have to
11 begin with the disclaimers. Although what I say certainly
12 comes out of my many years working in the antitrust section
13 of the California Attorney General's Office, I am not
14 speaking for the California Attorney General, nor am I
15 speaking for the Antitrust Task Force at NAAG, the National
16 Association of Attorneys General, with whom I frequently
17 find myself doing merger examinations, either just the
18 states together or in conjunction with Federal Trade
19 Commission or US DOJ.

20 Having said that, that is really the starting
21 point for my comments, because state AG merger review, as
22 well as selection of mergers to review, is very much colored
23 by first state and local agencies' experiences as purchasers
24 and/or regulators.

25 Second, the policy slant and the informational

1 network basically arise from the AG's other, more
2 traditional role as a consumer protection enforcer and
3 consumer protection advocate.

4 And, finally, our historic division of labor with
5 our federal colleagues, when we do work on these mergers in
6 which our primary focus is on local markets.

7 Our experience is more limited than the federal
8 agencies. California, for example, only looks at maybe five
9 to eight mergers per year. I know that is hard to imagine
10 for the fed. But certainly out of that comes very
11 consistent views, views that are consistent with the
12 observations of others here today that reliance on market
13 definitions and concentration formulas so as to determine
14 market power, while obviously understandable, given the need
15 to make a decision with major economic consequences under
16 time pressure, very frequently misses quite important
17 countervailing evidence and issues that should often be
18 determinative. So I very much applaud the decision here to
19 examine the need for and use of direct evidence to get at
20 the truth.

21 Local markets, let me just postulate that local
22 markets, in all their quirkiness and color, are the least
23 likely to conform to statistical norms or models. Reliable
24 data probably doesn't exist at the local level. Personal
25 relationships and local conditions are involved. Regulatory

1 restraints and even politics may affect it.

2 A competitive-effects analysis that recognizes
3 these things may not be easy, but it is more likely to be
4 correct. Let me draw on some examples. And, of course,
5 since we have Californians here, these are going to be
6 somewhat more familiar to you than they might be in a
7 different hearing.

8 First, from our personal file drawer, in 1999 the
9 Summit Medical Center merged with the Sutter Healthcare
10 System in Oakland, and we went to trial on that.

11 The *Elzinga-Hogarty* approach to defining
12 geographic market based on patient discharges by ZIP Codes
13 swept hospitals in San Francisco and as far down the
14 peninsula as, I believe under one version, even Stanford,
15 into the East Bay hospital market, if you can believe that,
16 and found that competition would therefore survive.

17 But the health insurers were all saying that their
18 East Bay patients wouldn't accept being sent to a hospital
19 on the other side of San Francisco Bay, that people were not
20 going to cross the Bay Bridge to San Francisco. They were
21 not going to cross the Hayward-San Mateo Bridge to get down
22 the peninsula.

23 Unfortunately, really, it was the
24 market-definition approach that prevailed in the end. Yet,
25 as we have since learned, the result of that merger was a

1 dramatic increase in prices, even though at least one health
2 insurer actually tried for some period, unsuccessfully, to
3 steer its customers to the wider, so-called competitive
4 market.

5 Another example in a somewhat broader market, but
6 still local in our view -- another illustration, basically,
7 that the assumptions that are made are by necessity
8 incomplete, and frequently the missing information is
9 critical, and you can't get that without a really close look
10 at direct evidence.

11 There are lots of examples of this, I'm sure we
12 can all think of them, but one of the bitterest ones for us
13 in California -- and this is a self-criticism, although
14 there were others involved -- had to do with oil company
15 mergers that were assumed to be benign, because nobody
16 really factored in the practical effects of California's
17 unique refining formulas on out-of-state sources of supply.

18 The importance of that information wasn't
19 recognized until way too late in the game. A number of
20 mergers had been consummated before anyone really woke up to
21 it. Interestingly, the first inklings about it, at least
22 for our office, came when we talked to truckers.

23 Another example that I want to mention, and one of
24 my colleagues who worked on a case like this is actually
25 here today, assumptions about market entry are certainly

1 rife with possibilities for missing important information.

2 In a local market, for example, what may be missed
3 is not just the effect of zoning restraints on new entry,
4 but even beyond that in a place like San Francisco -- and
5 our case had to do with movie theater multiplexes -- the
6 realities of land use permitting process go well beyond the
7 zoning.

8 The joint merger reviews that we do, and we do
9 usually quite smoothly with our federal colleagues, take
10 place under the federal/state protocols. Although we are
11 doing that, the state is actually going to be applying the
12 NAAG Horizontal Merger Guidelines.

13 Analytically, those are very much the same as the
14 federal Guidelines, except for a just a few points that I
15 think I would like to commend to your attention today.

16 The first is greater latitude to define narrow
17 markets based on recognizing that certain consumers are
18 vulnerable to price discrimination.

19 Now certainly the federal Guidelines also
20 recognize price discrimination. Both approaches really
21 treat price discrimination as a market definition issue, and
22 I think probably wrongly. The practical reality is that it
23 should serve to illustrate competitive effects.

24 A couple of examples I'll just cite to that. One
25 is there are theoretical competitive choices, let's say, as

1 to dialysis clinics. This is something that is a very
2 local-market-oriented issue that we have worked on with the
3 feds at times in the past. But whether it's dialysis
4 clinics or supermarkets, those choices may not exist for
5 people who rely on public transit.

6 Yet to try to define that as a separate market is
7 an exercise that you could spend a lot of time on and you
8 would end up with basically having learned not very much and
9 not being able to do anything with the market that you have
10 defined, if you have actually been able to define it.

11 Another example, rather different, there are quite
12 varying state laws on textbook content. And even in an area
13 where multiple competitors exist in theory, the long time it
14 takes to develop and the fact that there are these
15 differences, create pockets of opportunity for monopoly
16 pricing that can very easily get missed if you were focusing
17 on market definition.

18 The next area is efficiencies. The NAAG
19 Guidelines treat efficiencies much more skeptically. Of
20 course, this is where we, all of us enforcers, most famously
21 encounter spin.

22 Truthfully, I think the merging parties themselves
23 believe, or at least they hope, that the efficiencies' claim
24 will prove to be true.

25 In our experience, certainly courts, as well,

1 which are particularly reluctant to make bold decisions on
2 matters that are fraught with uncertainty, are also very
3 eager to drink that particular Kool-Aid. In that area,
4 looking at what's happened in similar mergers in the past
5 can be incredibly useful.

6 The NAAG approach actually treats historical
7 trends towards concentration and the details of the history
8 as a criterion that may legitimately bear on legality. What
9 we lack very often, though, is a lot of good information
10 about that historical pattern.

11 It should at least justify closer scrutiny. That,
12 presumably, is at least one of the purposes of the FTC's
13 retrospective studies. And the use of that information I
14 would like to see given an explicit place in the Guidelines.

15 We all know a great many stories, anecdotal only,
16 of unintended, very expensive and certainly
17 efficiency-neutralizing consequences of mergers, melding two
18 different corporate cultures. For example, commercial banks
19 merging with savings and loans, teaching hospitals merging
20 with regular ones.

21 I don't want to address a sore point here at
22 Stanford. And the need to hire back many physicians that
23 were supposed to be cut, as well, of course, as the
24 temptations to exercise newly found market power or perhaps
25 it doesn't rise necessarily to the definitional dignity of

1 market power, but let's call it market edge. It may well
2 overcome whatever disincentives to exercise that edge that
3 may have been identified in the review process.

4 One of the best outcomes of paying greater
5 attention to the results of analogous mergers would be the
6 tacit encouragement of economics departments in business
7 schools to generate more studies of them.

8 That would help all of us, certainly my office,
9 who are constantly in need of additional information,
10 economic information; build in more sophisticated
11 understanding of the realities.

12 In conclusion, I'll just mention one other
13 difference, just so as not to disappoint any of you who
14 expect radical talk from state antitrust enforcers.

15 I will mention that the NAAG Guidelines go beyond
16 the federal Guidelines in talking about wealth transfers
17 from consumers to producers by declaring that that is
18 actually the central purpose of Section 7 enforcement.

19 Since my colleague here has already been speaking
20 about consumer surplus, I think looking at that is perhaps
21 an alternate way of approaching wealth transfer. Maybe it's
22 not so radical after all when you think about it. Thank
23 you.

24 COMMISSIONER ROSCH: Thank you, Kathy.

25 Jeremy.

1 PROFESSOR BULOW: Thank you.

2 Regarding market definition, I'm reminded of a
3 visit that Bill Gates made to Stanford during the Microsoft
4 antitrust case. He said that Microsoft had four percent of
5 the software market and software was a highly competitive
6 industry with declining prices and increasing quality.

7 And then about ten minutes later he just couldn't
8 quite help himself, and he described how Office and Windows
9 were two of the five best businesses in the world, with 90
10 percent plus-profit margins and tremendous networking
11 advantages.

12 Before getting into the Merger Guidelines, I'd
13 like to take a step back and focus on the more general issue
14 of how noise in the decisionmaking process can be reduced.
15 I'm going to speak as someone who has spent time at the FTC,
16 not the DOJ.

17 The single best way to reduce noise regarding the
18 economic as opposed to the legal or political decisions
19 would be for the Commissioners to spend more time talking to
20 economists. I happened to take four courses at Yale Law
21 School.

22 So I have had more graduate law courses than most
23 Commissioners have had graduate economics courses.
24 Nevertheless, were I an FTC Commissioner I'd probably have
25 at least two, maybe as many as three of the four advisors in

1 my office be lawyers, recognizing that my law knowledge is
2 minimal relative to a professional attorney.

3 Similarly, I think each Commissioner should have
4 at least one and maybe two economists among their advisors.
5 Right now among the 20 advisors for five Commissioners, 19
6 are lawyers and one is a JD Ph.D. All the Commissioners,
7 even the new appointments, are lawyers.

8 Even though I'm sure that the Commissioners will
9 get great advice from Joe Farrell and Rich Feinstein, this
10 is a recipe for noisy decisionmaking.

11 When I was at the FTC only one Commissioner,
12 Commissioner Swindle, had an economist on his Staff. As a
13 result, even though there were two other Commissioners who
14 were much stronger academically than Commissioner Swindle,
15 his office tended to produce the best, most thoughtful
16 economic analysis of any of the Commissioners.

17 Second, I would note that in addition to the
18 Merger Guidelines the FTC publishes two other kinds of
19 information.

20 First is an estimate of how much money the
21 Agency's actions have saved consumers. This requirement is
22 not taken seriously. For example, except in exceptional
23 cases, the FTC estimates savings to consumers from any
24 action in any merger enforcement is equal to one percent of
25 sales in the market for two years.

1 Were the FTC to take this requirement more
2 seriously and provide analyses backing up its calculations
3 for consumer benefits, I think the eventual impact would be
4 more thoughtful and analytical decisionmaking with more
5 understanding of the need for economic analysis.

6 Third, after each action the FTC puts out
7 statements explaining the rationale behind its actions. If
8 these statements were written in a meaningful way there
9 might be little need for the Merger Guidelines. And, again,
10 I think the eventual impact would be better decisionmaking.

11 For example, even though I was heavily involved in
12 the Exxon Mobil case, there were certain things about the
13 divestiture order that I did not understand. I went to read
14 the justification afterwards and found it provided no
15 insight. My understanding is that, while Commissioner Muris
16 wanted to increase transparency, things are little changed
17 in the last ten years. An approach that provided a
18 rationale that was more similar to what a judge might write
19 up in deciding a case would be ideal.

20 As to the Merger Guidelines, one way to think of
21 the problem is as follows: In a second request, which is
22 analogous to a detailed audit, the Agencies use a variety of
23 information to determine whether or not an action is
24 required to protect consumers.

25 The Agencies make a rough decision about which

1 cases to audit, based on the preliminary information they
2 have. As with information the IRS provides about its audit
3 selection process, the Guidelines should be informative but
4 not too specific.

5 The Agencies should be able to list for firms the
6 key factors that are considered in their analyses, such as
7 market share, industry concentration, absolute size of
8 firms, substitutability of merged products, and perhaps
9 industry dummy variables, and discuss how they think about
10 these things, and how that thinking accords or does not
11 accord with modern economic analysis.

12 Significant changes in the Guidelines might be
13 thought of as changing the underlying structure of the
14 Agencies' screening and enforcement procedures, and
15 therefore, changing the relative importance of different
16 variables. Why am I biased towards a discussion of
17 variables rather than equations, such as the HHI that
18 purport to summarize them?

19 Well, I'm biased somewhat by my own work. While I
20 have only written a few papers in industrial economics, one
21 coined the terms, "strategic substitutes" and "strategic
22 complements," which illustrated how hard it is to predict
23 the strategic response of one firm to the actions of
24 another.

25 A second paper, which is actually related, pointed

1 out the difficulties in estimating pass-through rates due to
2 cost changes. The implication is that there is little that
3 we can directly predict about competitive pricing directions
4 strictly from theory.

5 Furthermore, price effects are not necessarily
6 dispositive about welfare effects. For example, say that
7 the technology for producing a differentiated product such
8 as women's clothing changes so that the fixed costs of
9 providing a new design is reduced.

10 We can predict that in the competitive model there
11 will be more variety and higher welfare, but we cannot make
12 predictions about whether prices will be higher or lower
13 without making abstruse assumptions about things like the
14 life concavity or life convexity of demand.

15 Furthermore, while we are ultimately interested in
16 the effect of a merger on price, quality, and variety, it is
17 not only difficult to do things like to find a market, which
18 leads some people to want to look at data-like margins to
19 estimate elasticities and then price effects, but it is
20 difficult to estimate margins appropriately.

21 When we calculate the margins for refiners, for
22 example, do we compare the price of gasoline with the price
23 of crude oil and so determine that the refining industry has
24 become more competitive when crude oil prices have doubled
25 and refining margins have risen by only 50 percent?

1 The implication of all this is that while it is
2 possible to discuss the factors that are likely to be
3 important in a merger analysis, I'm skeptical of the ability
4 to summarize competitive effects and the likelihood of
5 consumer harm with any simple equation that tries to combine
6 many factors.

7 What are the key factors that should be discussed
8 in the Merger Guidelines?

9 First, the existence of efficiencies that provide
10 the competitive rationale for a merger should be emphasized.
11 Efficiencies are basically complementarities on either the
12 cost side or the product development side that make the
13 joint firm able to make more value than it could through a
14 realistic alternative, such as a contract.

15 Cost savings that come about through obtaining
16 lower prices from suppliers must be looked at skeptically
17 because, if the suppliers are competitive, they will
18 eventually have to be paid their costs and the lower prices
19 will go away. And if the suppliers have market power, then
20 the impact on consumers of consolidating purchasing power of
21 the intermediate goods producers is ambiguous. In the case
22 of public company mergers, comparing these efficiencies,
23 which might reduce total cost rather than some definition of
24 marginal costs, with a premium paid in the merger may
25 provide information. Traditional issues of the feasibility

1 of entry and of the potential for consumer substitution to
2 other products also require consideration.

3 Finally, the Agencies must be concerned with
4 whether a merger would more closely align the interests of
5 the remaining competitors and so reduce the likelihood of
6 competitive conflict.

7 A deep discussion of these factors, combined with
8 consistent decisionmaking, rather than an emphasis on how
9 this information might be summarized in a particular
10 equation is what I would like to see.

11 COMMISSIONER ROSCH: Thank you very much, Jeremy.

12 Let me kick off the questions of our panelists.
13 And so that you can have a little time to think about them,
14 let me go ahead and kick them off, and then we'll turn to
15 everybody else.

16 Lawrence, the principal question I have got for
17 you is, how do you weigh factors? If we don't use economic
18 formula and we just list factors that we take into account,
19 how do you weigh them? How do you rank them? That's my
20 question for you.

21 With respect to Mark's comments, I have already
22 commented a little bit on them.

23 But I see Pam Cole sitting back there. And in the
24 *Oracle* case I always thought that one of the things that
25 Judge Walker was really focused on, although he didn't say

1 it, was that -- assume for the moment that Oracle and SAP
2 were the last people standing in this market.

3 I don't think that bothered him. And the reason
4 it didn't was because he felt that there were such
5 substantial upfront sunk costs in the form of R&D and maybe
6 fabs, I'm not sure, but more R&D in that case, that you lost
7 a tremendous amount if you lost a sale.

8 So that even if there were a duopoly market, that
9 you were going to have cutthroat competition between those
10 two people standing, no matter what. That simply
11 illustrates, I think, Mark's point that the current Merger
12 Guidelines with their emphasis on market definition and
13 structural analysis upfront creates kind of an artificial
14 certitude. So, anyway, I throw that out for comment, as
15 well.

16 With respect to Kathy's points, that was a very
17 rich discussion, and I have a lot of questions that arise
18 out of that, but I'll keep them to myself. Let me just say
19 one thing about one thing that she said, which is that
20 however sincerely people may really believe that their
21 transactions are going to yield efficiencies, frequently
22 they don't, and shouldn't we subject that to a higher
23 screen?

24 Michael Porter actually has made that same
25 observation, except his is even more trenchant. He would

1 suggest that very, very few mergers actually yield the
2 efficiencies that are expected. And instead they are very
3 inefficient, by and large.

4 With respect to Jeremy's observations, Jeremy, I
5 must say the notion of having more economists rather than
6 less on our Staffs -- and, I confess, in our office we have
7 four attorney advisors who are very fine attorneys. They
8 are not economists.

9 But why is that so? Why do I have a more of a
10 mistrust of economists? Well, two reasons.

11 I think the first is that I think Joe aptly said
12 at the table once upon a time that economists rarely win
13 cases in court, but they sure can lose them. And I think
14 that that is very definitely the case.

15 But quite apart from that, I must admit that I
16 have gone through at least three and maybe four different
17 kinds of economic analysis in my life, in my career, as a
18 lawyer. The first was big was bad when I started out.
19 The second was in the wake of *GTE Sylvania*, which was the
20 Chicago School. The third was kind of a modification of
21 that, suggested by Joe in some papers that he wrote where he
22 suggested that there was something called experimental
23 economics, that sellers rarely identified what was even best
24 and profit-maximizing for them upfront, but instead, through
25 a process of trial and error, blundered their way on through

1 to find out what was profit-maximizing for them. And then
2 most recently there is the behavioral economics school, and
3 I'm very concerned about the lack of an organizing principle
4 for that school, as well.

5 All of this leads me to wonder whether this search
6 for certitude, if you will, or predictability in terms of
7 backing into a market may not best be served by a very high
8 degree of transparency.

9 That is to say, what factors are really being
10 taken into account, not only in the second request process,
11 but also in court, in terms of backing into what a market
12 definition is. So I throw those out to each of you.

13 Lawrence, do you want to similarly identify
14 upfront any questions you have got of the panelists?

15 MR. WU: Sure. I think my question for Mark
16 Lemley and the panel in general is whether there is no room
17 for market definition and market concentration in helping
18 the Bar, and economists, and the business community
19 understand antitrust policy.

20 And, in particular, I'm thinking about what's
21 likely to be useful in the first, initial phase of the
22 waiting period. It's very hard to get evidence on
23 competitive effects, because not only must the parties
24 provide that evidence, but the FTC and DOJ staff must
25 evaluate and test it themselves.

1 I'm skeptical that all of this can be done in the
2 initial waiting period. So if that is the case, would you
3 still say that there is no room for market shares and
4 concentration in the process?

5 COMMISSIONER ROSCH: Okay. That's a question.
6 And, Mark, please address that when we get to you.

7 Kathy, what are your questions?

8 MS. FOOTE: My questions really relate to the
9 weighting of the evidence. And this is as much a question
10 to myself as it is to members of the panel. Firmly
11 believing, as I do, that this evidence is really important,
12 at what point does it become determinative?

13 COMMISSIONER ROSCH: Okay.

14 And, Jeremy?

15 PROFESSOR BULOW: Well, let me ask you a question,
16 Tom.

17 COMMISSIONER ROSCH: Okay. I deserve it, by the
18 way.

19 PROFESSOR BULOW: Yes. So, you know, what
20 economic analysis or research that has been done in the last
21 20 to 25 years does you and your office take into account in
22 coming to its decisions on antitrust cases?

23 COMMISSIONER ROSCH: Well, that is a perfectly
24 legitimate question. And I guess the answer is that we tend
25 to look at these through the lens of trial lawyers, because

1 we think that that is, generally speaking, how the staff is
2 going to analyze the transaction increasingly at the FTC,
3 because we are increasingly willing to litigate cases that
4 we think should be litigated.

5 And so they have to make an evaluation as to
6 whether or not those cases can be won. And those are the
7 factors that they take into account. As to specific
8 factors, I am concerned that any -- first of all, I am not a
9 fan of lists. I should say that upfront.

10 But that said, the Bar does need precise
11 identification. It deserves precise identification of as
12 many of the factors as we can possibly provide. And some of
13 those are going to be discussed today: Power buying, price
14 discrimination.

15 I think it makes a huge difference whether or not
16 there is an intermediary or a reseller involved in the chain
17 of distribution, because sometimes the reason that you don't
18 get a lot of complaints is because they can pass any price
19 increase along to the end user. So that is another one.

20 Kathy's observation that price discrimination is
21 arguably more relevant to a competitive-effects analysis
22 than it is to a structural analysis is probably apt. We do
23 take a look at that.

24 We certainly take a look at the increase on price.
25 We take a look at the increase on whether or not the

1 transaction is likely to increase innovation. And we do
2 take a look at history, very, very largely. Perhaps that is
3 -- in Jeremy's lingo and Lawrence's lingo that is called a
4 natural experiment, but we do take a look at history in
5 order to make that determination.

6 Now those are some of the factors, but I'm
7 concerned about the list being so short that it's used
8 against the staff in litigation by people who are very
9 skilled in that respect and also by judges who don't
10 understand these considerations as well as perhaps they
11 should. Okay.

12 Lawrence?

13 PROFESSOR BULOW: No specific stuff that has been
14 done in the last 20 or 25 years that you can think of?

15 COMMISSIONER ROSCH: You know, one of the things
16 that we did take a look at, Jeremy, -- and actually, your
17 point about -- I was glad you didn't mention retrospectives,
18 by the way, because I think they are very expensive to
19 conduct, particularly for the recipient of the
20 retrospective.

21 But the idea of issuing a closing statement, a
22 statement that explains why you didn't challenge a merger,
23 is a very good one. And I don't know that we have paid that
24 much attention to it. By far, I think the best one we have
25 done was in connection with this latest Merck -- I'm sorry

1 -- not Merck, but Kaiser transaction where we identified a
2 whole series of factors that we took into account, including
3 some that went to innovation.

4 And the staff really ran down those considerations
5 very, very completely. And the statement which the
6 Commission issued discussed those at some length. And
7 probably that does a better job than I can do on the fly
8 here.

9 Go ahead, Lawrence.

10 MR. WU: Okay. I'll start by talking about the
11 various types of evidence we can use to evaluate competitive
12 effects. And there are many types of analysis we can do,
13 from natural experiments to bidding studies, and the like.
14 So here's how I think about weighing the various pieces of
15 evidence. And there are a couple of different perspectives
16 we can take on this.

17 So here's one perspective. Okay. Let's take the
18 division between data versus qualitative evidence. Business
19 plans, interviews, and speeches, those are all important
20 qualitative pieces of evidence, but they are more difficult
21 to test and the credibility of a witness could be subject to
22 some criticism on the stand.

23 My preference would be to focus on empirical data,
24 empirical analyses. All the business documents may help us
25 in creating the propositions we want to test, but then I

1 would use an empirical analysis to test those propositions.
2 So if I had a choice between qualitative data and
3 quantitative data, I think the qualitative data allows for
4 more testing of propositions.

5 Let me think about weighing it from a different
6 perspective, and that is weighing on the kind of questions
7 that are at issue. Given the relevance and given the data
8 that are available there are different kinds of analyses we
9 can do. The analyses may address different types of
10 questions.

11 Some questions may be more important or
12 dispositive than others. In one case, it may be entry. In
13 another case, it may be efficiencies. In other cases it may
14 be substitution among different competing products. The
15 importance of a question to me will affect what weight I
16 give to a particular piece of evidence.

17 Another perspective has to do with the precision
18 of the results. With empirical analysis, the precision we
19 can evaluate statistically. And, as decision theory would
20 suggest, we ought to give more weight to results that can be
21 tested, replicated, subject to scientific scrutiny, and
22 results that are more precise. So, you know, those would be
23 factors, you know, I would consider.

24 So, again, this overall -- the theme here is I
25 think there is no one weighting, but the weights are going

1 to depend on the question at issue and how important that
2 issue is. And it goes to the reliability and confidence we
3 have in a particular result.

4 And that lastly I would say on the weighting is
5 that there is something called retrospective analyses. We
6 can go back and evaluate how important certain pieces of
7 evidence are, in general, if we wanted to. We could also go
8 back and think about it in a particular case.

9 And I think that kind of ex-post study is
10 important and I think the Agencies ought to consider doing
11 that. The Agencies already do that in many ways, and I
12 think that is something that we could continue.

13 And I'll even say something as it relates to the
14 HHI and possibly the concentration threshold. The Agencies
15 have data on transactions over the past decade. Analysis of
16 that can be useful in evaluating what a safe harbor
17 threshold might be.

18 And even then, ex-post, even if some transactions
19 are cleared, there is an opportunity later to evaluate
20 whether that was the right decision. And I think if you
21 think about it in that dynamic way that you might set some
22 thresholds and later evaluate and revise accordingly. I
23 think that is a sensible, empirical way of thinking about
24 policies.

25 Mark.

1 PROFESSOR LEMLEY: All right. So I think one of
2 the significant things to understand about a focus on direct
3 effects rather than on market share and concentration
4 thresholds is that it can, in appropriate cases, push
5 towards either more or less antitrust scrutiny than we
6 currently have.

7 So is it possible that hard-fought duopoly can
8 prevent any substantial competitive harm? Yes. Did that
9 happen in *Oracle PeopleSoft*? There, I'm a bit more
10 skeptical.

11 The part of the problem is actually that our
12 economic theories around the behavior of duopolists are
13 surprisingly diverse. We have a variety of different
14 predictions as to how duopolists will behave. And it's not
15 clear, actually, how those are borne out empirically.

16 I think you would, certainly, in a duopoly
17 situation, even if we thought these companies were really
18 competing strongly, we would tend to worry about concerted
19 effects as to new customers, and so forth. You would want
20 to sort of look very carefully at the benefits to the
21 merger.

22 Now Lawrence asked me is there no room for market
23 definition here. I think the right answer is, look, there
24 is always room to talk about the competitors that you face
25 in the marketplace, because those competitors are going to

1 be relevant to whether or not there is going to be harm from
2 a merger.

3 But the right way to talk about it is not, look, I
4 have x number of competitors in the marketplace and because
5 I got over the magic number let's stop having the
6 conversation. I think the right way to think about it is to
7 say if I can point to the presence of a bunch of competitors
8 that we agree are, in fact, competing with me or are
9 constraining my behavior, that fact is going to make direct
10 anticompetitive effects from a merger unlikely.

11 Now, I did want to actually sort of throw out a
12 question for the panel, as well. This is sort of two, to
13 me, quite related questions. One of the things I noted in
14 listening to the panel is a split between -- I don't know if
15 it's the Stanford/non-Stanford people or what -- between
16 Jeremy and I on the one hand, who I take it to view the goal
17 here as a social surplus, as incorporating efficiencies on
18 the producers' side as well as consumer surplus, and Kathy
19 and Lawrence on the other hand, who I heard as saying the
20 proper, exclusive focus is consumer surplus alone.

21 I guess I'm sort of curious for Kathy and
22 Lawrence, why you would not incorporate a producer surplus.
23 And, in particular, this relates to an issue that Kathy
24 raised, which is the role of price discrimination.

25 I mean, I take it that how we evaluate price

1 discrimination is going to differ quite dramatically,
2 depending on whether we think that the proper unit of
3 analysis is social surplus, in which case much of the effect
4 of price discrimination, though perhaps not all, is a wealth
5 transfer, or if we think it's purely consumer surplus in
6 which case the fact that it is a wealth transfer is going to
7 line up pretty heavily on the anticompetitive ledger.

8 COMMISSIONER ROSCH: Kathy.

9 MS. FOOTE: Several comments.

10 First, the interviews that generally launch a
11 merger investigation are just a treasure trove of
12 information. My office obviously participates with FTC and
13 DOJ on many of those.

14 So the question really is, where does it go, and
15 what is done with it, and can more be done with it.

16 Certainly the interviews inform the second
17 request. But after that a lot of it sort of vanishes. It
18 goes into the ozone. It may certainly factor into the
19 internal analysis, but the learning from it ultimately may
20 be lost.

21 Possibly that is because the decision, which in
22 most cases involves either a decision not to go forward or a
23 settlement, is to some extent opaque, and so a lot of that
24 texture is lost. But if there are ways to carry that
25 learning forward, and the closing statement idea may

1 actually be a good way of doing that.

2 Secondly, with regard to weight of the sort of
3 competitive effects factors, I think that really has to
4 focus on the notion of what is going to influence a judge.
5 The judge is sitting there, with the rare exception of
6 someone like Vaughn Walker -- the judge is sitting there not
7 really knowing a lot about the situation, under a great deal
8 of pressure to decide something very important and very
9 uncertain.

10 And what will enable that judge to really break
11 out of a kind of a wooden reliance on balancing of expert
12 testimony and actually evaluate evidence as that same judge
13 would do with a great deal of comfort in a nonmerger case.

14 With regard to that one thing that may be useful
15 is essentially to kind of expand the roster of experts so
16 that it is not just one expert economist against the other.

17 Now frequently the economist is the surrogate for
18 a lot of other expertises, for the businessperson's
19 expertise, what other hospital administrators actually
20 believe to be the case, or what the traffic engineer really
21 has to say about crossing bridges, if we want to take our
22 Sutter example.

23 And all of that is somehow or other wrapped into
24 the economist's testimony. It might be -- it is certainly
25 more arduous and it will take more time at trial, but to

1 actually bring those experts and hear what they have to say
2 in court where it is, where the investigation up until that
3 point really, really does point to its being a critical
4 piece of information without which the other analysis is
5 really going to go sideways.

6 Finally, I just mentioned to Mark, social surplus
7 I think is where certainly our approach tends to be. And
8 that is, I think, the cause of our -- the fact that the
9 state AGs do come at this from a kind of a consumer
10 protection end of things, which covers a lot of bases other
11 than just price.

12 COMMISSIONER ROSCH: Jeremy.

13 PROFESSOR BULOW: Yes. Well, first, you know, I
14 want to comment on Tom's remark that economists can lose
15 cases.

16 COMMISSIONER ROSCH: Oh, I was being catty.

17 PROFESSOR BULOW: Very few FTC cases have the
18 remotest chance of going to litigation. And when they do
19 and it's a big one, they hire outside counsel. I mean, the
20 vast majority of the lawyers in the "Bureau of Competition"
21 are never going to be in a case. And I think that is a poor
22 justification for the four-to-one ratio of lawyers to
23 economists on the competition side.

24 I'm kind of reminded of the story that my
25 undergraduate advisor, James Tobin, told when he won the

1 Nobel Prize in Economics for his work on portfolio theory,
2 and he was asked to explain it to a newspaper. He tried to
3 explain it, and the guy said to make it simpler. And he
4 tried to explain it again, and the guy said: Can you make
5 it simpler? And, finally, he said, "Well, don't put all
6 your eggs in one basket." So the next day the story comes
7 out in the newspaper, Economist Wins Nobel Prize for Theory,
8 don't put all your eggs in one basket. Well, at some level,
9 at that point, the newspaper guy thought he understood what
10 Tobin had done. But, of course, he didn't because he didn't
11 have the training and he couldn't really understand it at a
12 very subtle level. He could understand it at a sort of
13 supersimplistic level. And if he thought that was all there
14 was to it then, he's going to think, well, what is there to
15 economics? I think there is a certain amount of that going
16 on. And you know maybe the best way to describe it is, I
17 have heard antitrust lawyers refer to Robert Bork and the
18 Chicago School as the "new economics," and that is 1970 to
19 1975. It's sort of way out of date.

20 I think not realizing that science marches on, but
21 there is a lot to learn. There are a lot of things that
22 people know outside of your field that are really important.
23 The analogy would be, let's say, you took your view of the
24 legal profession from watching "The Paper Chase," and you
25 said -- you saw the students go up and get Kingsfield's

1 notes and say: Well, now that I have got Kingsfield's notes
2 from 30 years ago, I'm able to ace the class, because you
3 know what's going to happen in the last 30 years.

4 I mean it's not that way, I'm sure. I'm sure that
5 part of the reason, Tom, that you have four attorney
6 advisors is because you realize that there are a lot of
7 complicated questions in the law. And even if you were
8 trying to explain to somebody like me, who doesn't know that
9 much about it, you would have to give me the "Don't put all
10 your eggs in one basket" version so that I could sort of
11 understand that there is a lot else going on.

12 And so the fact that you know that you can make
13 use of four lawyers in a field where you know something
14 about, you should realize that there are other fields out
15 there like economics, which people think are relevant to
16 antitrust, I mean some people think it's relevant to
17 antitrust, and just kind of keep in mind that you should
18 try to know that there may be things you don't know.

19 The last thing is in terms of retrospective
20 commentary, I actually think it would be great if the FTC
21 and the Justice Department put significant resources into
22 explaining in a serious way what they did in each case, and
23 why and how much, to the extent, when they do an
24 intervention, how much they think that intervention is
25 saving.

1 Yes, it would cost a lot of money. Yes, it would
2 require hiring more economists if you really wanted to do it
3 seriously, I think. However, I think it would also help
4 provide a lot more clarity to people going forward.

5 You look at a lot of the cases that I saw in my
6 two and a half years, and I think it would have been very
7 difficult for somebody to look at the decision and say, 'You
8 know, gee, how can I figure out what's going to happen
9 next,' even though you had Commissioners who were smart
10 people working very hard trying to do the right thing.

11 So I think that having serious retrospectives,
12 while they might be costly, they might provide a lot of help
13 in future cases and they might actually reduce a conflict
14 and make it easier for antitrust lawyers advising their
15 clients with the help of economists to figure out what might
16 work for them and what might not.

17 COMMISSIONER ROSCH: Well, thank you, Jeremy. I
18 think we all need to be reminded and me, particularly, that
19 a good dose of humility is warranted here.

20 Carl, indulge me just to take a few questions from
21 the audience, because you guys started 15 minutes late, and
22 as a result we started 15 minutes late. So let me just take
23 three questions from the audience, okay? Yes.

24 PROFESSOR SHAPIRO: Yes.

25 PROFESSOR VARIAN: So prior to the review of

1 definition of market, there might need to be a definition of
2 merger review overall; generally what sorts of cases prior
3 analysis shows are problematic. I'm thinking of situations
4 where everybody selects a ballot. Their cases were the one
5 firm in history is a natural, most expeditious supplier to
6 the other firms who use it, and it happens all over to the
7 place.

8 And I would argue that those business deals were
9 easily undone. There is no scrambling the eggs. Those
10 cases are much better, looking at another perspective, point
11 of view. That is, you notify the people: Well, there may
12 be competitive issues here, but this easily could undo or
13 reverse deal, go ahead and do it, but it could take a year
14 or two.

15 COMMISSIONER ROSCH: Okay. All right.

16 PROFESSOR SHAPIRO: So can I -- are we responding
17 to these, or do you just want to --

18 THE REPORTER: I am not getting the question on
19 the record.

20 COMMISSIONER ROSCH: Okay. Well, the question was
21 -- actually, it wasn't really a question so much as it was a
22 comment. There are some deals which, on their face, may
23 look like they are anticompetitive in effect, but they
24 aren't. And we ought to be able to identify those upfront
25 without a very lengthy inquiry into structural issues.

1 PROFESSOR SHAPIRO: I'll make sure I bring this to
2 the questioner. Okay.

3 COMMISSIONER ROSCH: Okay. Sure.

4 PROFESSOR LEMLEY: Yes. So I understood Hal, I
5 thought, to be going in a somewhat different direction,
6 right, which is that maybe what we can do is have a kind of
7 trial merger period in which we let you merge, but if it
8 turns out that this was a problem we break it up later.

9 I can imagine circumstances in which that would
10 actually work, but I could also imagine circumstances in
11 which it would be a disaster, right.

12 And so one of the things that you would want to
13 pay attention to, I think, is whether there is a real
14 plausible claim of efficiencies in integration, as opposed
15 to efficiencies in supply, and so forth, because if the
16 point of a merger is efficiencies in integration, then one
17 of two things is going to happen.

18 One is you are going to have something that is
19 really hard to unravel if it turns out after the fact that
20 you wish you hadn't allowed it, or you are going to have a
21 company that, during this trial period, doesn't actually get
22 any of those efficiency benefits because they are unwilling
23 to really integrate their units until they are sure that
24 they are not going to be unraveled, in which case you have
25 skewed the measure of whether or not it's, in fact, not good

1 for competition.

2 I mean, I have been kind of playing with the idea
3 of: Is there a way to sort of either allow a merger on
4 probation, or the alternative I guess would be to look at
5 the possibility of remedies short of unraveling the merger
6 in the circumstance in which you later decided it was
7 anticompetitive, right.

8 There may be circumstances in which we said we are
9 dubious about this merger. We are going to allow it to go
10 through, but we reserve the right to years from now to come
11 back and impose certain conditions on the merged company to
12 try to restore competition if, in fact, it turns out to be
13 necessary.

14 COMMISSIONER ROSCH: Go ahead.

15 Why don't you introduce yourself before you ask a
16 question?

17 MS. COLE: Hi, everybody. I'm Pam Cole. I work
18 for the Antitrust Division in San Francisco. This is
19 actually a common question I think I'm going to have
20 throughout the day, and that question is whether or not the
21 Merger Guidelines do a good job of helping staffers, such as
22 myself, assess the likelihood of some type of
23 postmerger-coordinated activity by the merged firm.

24 I see that there is a panel on unilateral effects
25 and there is a panel on price discrimination, but I think we

1 also have to think about coordinated activity in the
2 postmerger world.

3 Commissioner Rosch commented on the fact that
4 Judge Walker didn't seem bothered by the fact that even if
5 *Oracle* and *SAP* were the two companies left standing there
6 would have been no anticompetitive effect. I think that may
7 have partially been because the Justice Department really
8 based its case on unilateral effects and localized
9 competition between *Oracle* and *PeopleSoft*.

10 So often perhaps some type of postmerger
11 coordinated activity between *Oracle* and *SAP* in terms of
12 focusing on certain industry verticals, or whatever. So I
13 just want to throw: Any thoughts that you have in terms of
14 whether or not you think the Guidelines do a good job in
15 terms of helping the staff, such as myself, analyze possible
16 postmerger-coordinated activity in the market.

17 COMMISSIONER ROSCH: I think they do a -- I told
18 Carl this -- I think they do a terrible job.

19 First of all, because, as Professor Whinston
20 observed in the last panel of this kind, it's very strongly
21 arguable that the same kind of analysis that we engage in
22 with respect to unilateral effects and coordinated effects,
23 it's the same.

24 He makes a strong argument that that is the case.
25 And I'd like Carl and Joe to give that some thought as

1 economists, frankly, because it may be the case. I'm not
2 enough of an economist, as Jeremy has pointed out, to
3 really, really --

4 (Laughter.)

5 COMMISSIONER ROSCH: -- analyze that through.
6 But, in any event, that is his observation, and he is a very
7 distinguished economist.

8 PROFESSOR BULOW: There may be legal issues in
9 some of these decisions that have nothing to do with
10 economics.

11 COMMISSIONER ROSCH: The second --

12 PROFESSOR BULOW: It causes them to do what they
13 do, I suppose.

14 COMMISSIONER ROSCH: Right.

15 The second point is this, Pam. And this is the
16 point I made to Carl. In most unilateral effects cases you
17 also have a coordinated effects story. And I can't, for the
18 life of me, figure out why the staffs have drawn this
19 dichotomy between coordinated effects and unilateral effects
20 because, in most cases, there are problems with respect to
21 coordinated effects, as well as problems with respect to
22 unilateral effects.

23 With respect to Oracle, the Division did a
24 miserable job in that case of developing a coordinated
25 effects story, at least from my standpoint. It wasn't until

1 the 11th hour that they argued, and it was way too late in
2 the game at that point, that there is more than one possible
3 coordinated effects.

4 We focus on coordinated pricing effects. And the
5 economists are always telling us that that particular
6 problem is eliminated if pricing is opaque, because it's bid
7 pricing.

8 But the problem of customer allocation, of market
9 division is not eliminated by opaque pricing. And that is a
10 real possibility in a lot of so-called unilateral effects
11 cases.

12 MR. FARRELL: Joe Farrell.

13 The main thing I would say is, don't go away.
14 Hang on for this afternoon's session entitled, "Unilateral
15 Effects," because one of the issues that I do want to pose
16 there is precisely: To what extent does the analysis shade
17 over and to what extent are the two theories of concern not
18 as strictly separated as one might think by reading the '92
19 Guidelines. So we'll get into all that this afternoon.

20 COMMISSIONER ROSCH: Okay. Thank you.

21 PROFESSOR SHAPIRO: We do allow these
22 advertisements during the middle of a session in special
23 cases.

24 COMMISSIONER ROSCH: Final, final comment.

25 MR. McCAULEY: Good morning. My name is Ryan

1 McCauley. I'm curious. So going back to decision theory
2 and design in the certainty that we provide to corporations
3 or not that are looking at merging. Is there something that
4 is an alternative to HHI?

5 So I think that there is been some discussion of
6 price pressure index, PPI, is that the proper acronym, a
7 more upward price pressure index. Does that serve as some
8 substitute that would be acceptable, as opposed to HHI and
9 the traditional market definition measures that we go
10 through?

11 COMMISSIONER ROSCH: You can very briefly comment
12 on that.

13 MR. WU: The upward pricing pressure is useful
14 because it focuses us on things that I think really are
15 useful, looking at elasticities of demand, looking at
16 substitutes, looking at close margins. And that is all very
17 useful. And so I think that that is why that approach is
18 useful. It takes us away from market shares and market
19 concentration.

20 COMMISSIONER ROSCH: Mark.

21 PROFESSOR LEMLEY: Well, so I think the answer is
22 yes, but. So I agree with Lawrence, it's useful. But then
23 I think there are going to be circumstances in which it's
24 not going to be the right solution. What happens when we
25 have declining price markets?

1 Do we have to worry about a *Cellophane* problem, --
2 it is not to say, don't pay attention to it, but it would
3 make me reluctant to identify this as a kind of rule-based
4 screen. You know, if a PPI is over a certain number then
5 challenge. If not, no challenge, without further analysis.

6 MS. FOOTE: I'm just a lawyer.

7 COMMISSIONER ROSCH: Okay. So I guess Jeremy.

8 PROFESSOR BULOW: So I think we are talking about
9 the index that Joe and Carl wrote about, for example, in
10 2008. It's a tool that would be useful in some cases, but
11 not necessarily every case, just like, the Herfindahl Index.

12 When you are trying to model a particular industry
13 or analyze a particular industry, sometimes one kind of
14 model is appropriate or relatively easy to use. Sometimes,
15 it's not. Even in Joe and Carl's model, there are certain
16 variables such as the profit margin that the firm is making
17 that you have to be able to estimate well to be able to use
18 the model. And sometimes there is going to be some
19 ambiguity to that. So it is the kind of thing that I think
20 that probably in a lot of investigations is going to turn
21 out to be useful, but I'd agree with Mark that you wouldn't
22 want to use any one thing like that and say that is an
23 absolute screen. I don't think there is anything that you
24 would want to use as an absolute screen, because the idea of
25 the tool I think is that it helps in a lot of cases, but not

1 necessarily that it's helpful all the time.

2 COMMISSIONER ROSCH: Okay. Carl.

3 PROFESSOR SHAPIRO: Okay. Thank you, Tom, and the
4 panelists. We'll take a 15-minute break. So around 11:15
5 we'll resume. There are restrooms downstairs, critical
6 information, and coffee and other things over here.

7 (Recess taken from 11:03 a.m. to 11:21 a.m.)

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1 **PANEL 2: PRICE DISCRIMINATION AND LARGE BUYERS**

2 **MODERATOR: CARL SHAPIRO**

3 **PANELISTS: HAL R. VARIAN, Chief Economist, Google, Inc.**

4 **CRAIG WALDMAN, Partner, Jones Day**

5 **KAREN E. SILVERMAN, Partner, Latham and**

6 **Watkins, LLP**

7 **J. DOUGLAS ZONA, Vice President, Charles**

8 **River Associates**

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10 PROFESSOR SHAPIRO: Okay. Let us resume. So have
11 a seat.

12 This panel is on "Price Discrimination and Large
13 Buyers." I really want to thank all the panelists. Let me
14 just go down and identify them without going into details.

15 But Craig Waldman on my immediate left, partner at
16 Jones Day; Hal Varian, Chief Economist at Google and, well,
17 I have to add that Hal, he is also still a professor at
18 Berkeley, although on leave; Doug Zona, Vice President at
19 Charles River Associates; and Karen Silverman, who's a
20 partner at Latham and Watkins.

21 So thank you all on the panel for coming here.
22 I'm very pleased that both Agencies can get the benefits of
23 the experience and knowledge of the panelists here, which
24 spans considerable academic experience and great practical
25 experience as well.

1 So let me set things up. First, there really are
2 somewhat distinct. Price discrimination and large buyers
3 are slightly different topics. They're related. Price
4 discrimination is addressed in the Guidelines, and I'll talk
5 about that in a moment. And we have already heard a bit
6 about it in the preceding panel.

7 Large buyers, as such, is not directly addressed
8 in our Guidelines. We've taken note that the European
9 Commission's Merger Guidelines that were put forth in 2004
10 have a section on large buyers. And the one natural place
11 to look is to look at that and see whether we could benefit
12 from something like that, or at least address the same
13 issues.

14 So we are going to take those in turn in our
15 discussion after each of the panelists -- we'll follow the
16 same format -- gives their introductory comment.

17 Let me say a few words about price discrimination,
18 both somewhat how I perceived this before I took my current
19 job, and then what I have seen in the ten months since I
20 have been at DOJ.

21 In a lot of markets, there is some price
22 discrimination by the sellers. And that is, I would say,
23 particularly true in a lot of the high-tech markets or the
24 innovative markets that, we are naturally thinking about
25 being out here at Stanford. Different, to some extent,

1 based on product differentiation, different products for
2 different customer groups. In other cases more traditional,
3 classic price discrimination, different prices for different
4 sets of users.

5 The Merger Guidelines -- and a lot of our analysis
6 when we look at competitive effects, which is most of what
7 we do in a merger analysis, we are looking at possibly,
8 let's say, differential effects of the merger on different
9 groups of customers even within a broad market or a market
10 that you might define nonuniform competitive effects. And
11 it's closely related to price discrimination.

12 Now the Guidelines, as they are written, I mean,
13 the current Guidelines, say very little about price
14 discrimination. I happen to think what they say is
15 perfectly correct, with maybe a few tweaks, but it's rather
16 terse. And I think one of the issues is can we elaborate on
17 it, explain how these things are done, you know, just --
18 it's rather terse and maybe even opaque.

19 There are essentially two or three paragraphs in
20 the whole Guidelines that address price discrimination,
21 which is put forward as there is the main analysis, which is
22 when there is no price discrimination. And then there are
23 these paragraphs that say a different analysis applies where
24 price discrimination would be profitable for a hypothetical
25 monopolist.

1 Both of these paragraphs occur in the market
2 definition section. So one of the issues, some could say
3 failings of the Guidelines, is that they don't really talk
4 about price discrimination much, if at all, in terms of the
5 analysis of competitive effects.

6 It's framed in terms of the market definition
7 step, and we already learned from Professor Lemley that
8 market definition is not the be-all and end-all of merger
9 analysis. So this discussion is framed in terms of, well,
10 let's say, existing buyers sometimes will differ
11 significantly in their likelihood of switching to other
12 products in response to a small but significant and
13 nontransitory price increase.

14 If the hypothetical monopolist -- there we are in
15 that context -- can identify and price differently to those
16 buyers, targeted buyers, it would not defeat the targeted
17 price increase, dah-dah-dah-dah, then the hypothetical
18 monopolist could profitably impose a discriminatory price
19 increase and the Agencies will consider markets defined
20 consisting of a particular use or uses by groups of buyers
21 of the product for which the hypothetical monopolist would
22 profitably impose this SSNIP, and separately impose at least
23 a SSNIP.

24 So that is the framework, but then there is
25 essentially really nothing much, virtually nothing else said

1 about how you would do this, when is it applicable, what
2 does it imply for competitive effects, other than you would
3 have defined those markets separately.

4 So that to me is a frame of where we are looking
5 for information from the more of an academic setting,
6 economic setting, practitioner setting. Now how is that
7 taken onboard and practiced in markets where there could be
8 -- you know the Agencies might say or maybe the merging
9 parties would agree or not that if there is price
10 discrimination, where does the analyses go with that.

11 Let me mention one case just to make it a little
12 more concrete, bring it alive a little more, that is
13 described in the Commentary from 2006, just so that this
14 isn't entirely, you know, conceptual, I guess, at least my
15 setup here. And this is one example. And, as economists
16 know and everybody knows, there are myriad methods of price
17 discrimination, some of which were catalogued by Pigou in
18 the 1920s. And so any one example is just that. It's one
19 example of price discrimination.

20 And the case I'm referring to is the Quest Unilab
21 merger that the FTC reviewed and I believe challenged in
22 2003. So these were two companies in -- appropriately
23 enough it involved Northern California here -- clinical lab
24 testing services. And so this a lab. You know, when you go
25 to the lab and you get your blood tests and other tests.

1 So according to the Commentary -- and I don't know
2 about the case from personal experience -- these testing
3 services are sold to physician groups, as well as health
4 insurers and hospitals, at least three types of customers.
5 There may be more.

6 And the concern, at least as described in the
7 Commentary, was the market for clinical lab testing services
8 as sold to physician groups. Okay. So that would be a
9 price discrimination market. That group was viewed as
10 vulnerable or more vulnerable than the other groups.

11 And if you have that situation, what do you need
12 in order for that to hold up. What would you do in terms of
13 measuring market shares? How would you evaluate competitive
14 effects for that group, when they may not be applying to the
15 hospitals and its competitive effects for the physician
16 groups when they may not be alleged or as significant for
17 health insurers or hospitals?

18 So there are many other examples. Geographic
19 price discrimination is another important one. So that is
20 the type of thing where Guidelines are spare and we want to
21 learn more about how this works out in practice and how they
22 could be improved. Okay.

23 So I'd like to turn first to Hal Varian in no
24 small part because Hal is one of the people who's done
25 fundamental academic work on price discrimination. And he

1 happens to be the Chief Economist at Google, so maybe he
2 knows a little about the pricing, as well, in practice.
3 Hal.

4 PROFESSOR VARIAN: So thank you very much for that
5 introduction. I want to make some general comments about
6 price discrimination.

7 As Carl mentioned, the Merger Guidelines only
8 refer to this in two places: In Section 1, Overview, and
9 Section 1.12. They point out that there could be several
10 relevant markets if there are several distinct buying
11 groups.

12 And the simplest case is, of course, geographic
13 markets where there could be a more or less competitive
14 environment and different geographies. Kathleen, the
15 textbook example is a very nice example of that.

16 You would also imagine in a number of other ways
17 that you could look at market segments, such as business
18 users, personal users, high-volume users, low-volume users,
19 luxury goods, ordinary consumers.

20 Kind of a nice case in point is airline mergers
21 where you could have business travelers and tourist
22 travelers that are affected differently. And, in fact, they
23 have very different needs based on very different prices
24 depending on the competitive circumstances.

25 So as Carl mentioned, this discussion that is

1 currently there is very brief. And I think it makes sense
2 to enlarge it by considering a few more examples of this
3 sort, mainly to discuss the prevalence of price
4 discrimination, why it is important now and I think a more
5 important issue in the future.

6 I'll start my general observations by saying I
7 think we should have two cheers for price discrimination.
8 It's good to point out that price discrimination is in
9 itself not a bad thing. In fact, in many cases differential
10 pricing allows for consumers to be served who otherwise
11 wouldn't be served.

12 As Mark Lemley alluded to a few minutes ago and I
13 think most if not all economists recognize this point, but
14 almost no one else does so it's probably a good idea to
15 spell it out in a sentence or two.

16 Now I mentioned that price discrimination was very
17 prevalent. And for some markets I think it may be really
18 the only viable form of pricing. So a noteworthy example
19 might be markets for information goods like books,
20 magazines, newspaper, software, data, et cetera, where there
21 is a very high fixed cost, a very low marginal cost, low
22 cost of entry, particularly today. And so product
23 differentiation is absolutely critical.

24 Some sort of product versioning is going to be, I
25 think, an inevitable outcome in most of these markets. And

1 so there will be associated differential pricing along with
2 this.

3 The other case that I think is particularly
4 noteworthy is B-to-B markets where prices are very commonly
5 negotiated by sales teams. And so price discrimination is
6 really the norm for many B-to-B transactions.

7 So I think that raises two issues. One is the
8 market definition problem should be thought of in terms of a
9 bargaining problem. That means you want to have serious
10 consideration of what outside options look like for the
11 bargaining participants. Furthermore, since the bargaining
12 and negotiations are often multidimensional, it's important
13 to look at factors other than price alone.

14 This is what Commissioner Rosch mentioned this
15 morning. For example, in some negotiations one party might
16 receive a low price in exchange for previous behavior as
17 with a loyalty program, or in anticipation of future
18 behavior as with penetration pricing, or due to some other
19 transaction that is taking place with the same parties as
20 with bundling. And all of these, of course, are forms of
21 price discrimination.

22 Now they are not necessarily harmful to consumer
23 welfare or, in this case, business welfare in and of
24 themselves. What's necessary is to look at the impact of
25 those practices on competition. So loyalty prices could be

1 used in some circumstances to discourage entry.

2 Penetration pricing could potentially, in some
3 circumstances, be confused with predatory pricing. And then
4 the line between bundling and tying is sometimes difficult
5 to discern. So they aren't necessarily bad, but potentially
6 in some cases it could be used in ways that have an adverse
7 impact on competition.

8 As we all know, these issues about differential
9 pricing in B-to-B markets arose in the *Microsoft* case, the
10 *Oracle-PeopleSoft* case, many other cases. And I think it
11 would be very helpful in the Merger Guidelines to mention
12 some of the considerations I just alluded to.

13 Now the case that Carl mentioned earlier about big
14 buyers is a particularly interesting form of price
15 discrimination. And so the argument there is that two
16 merging firms may argue that their combined market share is
17 not worrisome, since the ability of the merged firm to set
18 prices will be disciplined or limited by the presence of
19 large buyers who have maybe a lot of bargaining power.

20 I think to examine this kind of argument you have
21 to look specifically at the situation of the buyers to
22 identify that source of claimed bargaining power. Even
23 large buyers could have few alternative suppliers in some
24 situations, so a big buyer doesn't necessarily mean big
25 bargaining power. Everything depends on what the outside

1 options look like in that particular bargaining and
2 negotiation problem.

3 Secondly, even if the big buyers have sufficient
4 bargaining power that allows them to continue to pay low
5 prices after the merger takes place, small buyers or any
6 buyer without good alternatives may well wind up facing
7 higher prices, and the impact of those higher prices on the
8 small buyers could be a relevant consideration.

9 Just to take a very extreme case to illustrate
10 what I'm thinking about, imagine a situation where you have
11 something like an office supply market where there are
12 relatively undifferentiated products. A large firm might
13 set up a procurement auction to have people to compete in
14 supplying you with pens, and pencils, and yellow pads, and
15 paperclips, and all these things.

16 And, in fact, there are now many web services who
17 will actually run these procurement auctions for you. And
18 they actually tend to end up with much reduced prices when
19 you sell things by an auction as opposed to just individual
20 bargains. So the prices may well end up being close to
21 marginal cost.

22 However, if the two firms merged that were
23 previously competing in these procurement auctions so there
24 is only a single supplier now then, of course, the
25 competitive forces would disappear. You'd likely see a

1 higher negotiated price coupled with significant price
2 discrimination. So clearly the relevant issue is whether a
3 buyer, big or small, has alternative sources of supply after
4 the merger.

5 So to summarize this case about big buyers, for
6 the big buyers' argument to really exert substantial price
7 discipline it would seem you would have to satisfy the
8 following three conditions:

9 One, price discrimination is not feasible for some
10 reason. Exactly why that is should be investigated.

11 Two, the big buyers are large enough so they are a
12 significant consideration to pricing decision when it sets
13 this assumed single price.

14 And, finally, the big buyers have a credible
15 alternative source of supply. And I think those sorts of
16 issues should be spelled out in a document. Thank you.

17 PROFESSOR SHAPIRO: Okay. So actually, though,
18 let me just ask Hal. So in this last, the big buyer
19 discussion --

20 PROFESSOR VARIAN: Right.

21 PROFESSOR SHAPIRO: -- you just did, so you said
22 the big buyers -- if I can paraphrase; tell me if I got it
23 wrong -- the big buyers might protect the whole market if
24 the suppliers who are merging cannot price discriminate.

25 PROFESSOR VARIAN: Yes. Yes.

1 PROFESSOR SHAPIRO: Okay. So if we observe before
2 the merger that the big buyers are getting better deals from
3 the merging firms -- that has been the history. We often
4 see that, and we often hear that. And that can be put
5 forward as an argument, the merged companies say: Look,
6 these big buyers, they've got a lot of power. We are forced
7 to give them a really good deal.

8 So then that would presumably take us out of
9 your --

10 PROFESSOR VARIAN: Yes, exactly.

11 PROFESSOR SHAPIRO: -- place because that would
12 demonstrate price discrimination is feasible.

13 PROFESSOR VARIAN: Right. If they are, in fact,
14 engaging in price discrimination prior to the merger, then
15 there is no reason why they couldn't price-discriminate
16 after the merger. And if they are price-discriminating
17 after the merger, then the big-buyer argument loses a lot of
18 credibility.

19 So maybe I stated it in terms of a negative. I
20 said: For the big buyer argument to exert substantial price
21 discipline you would have to have these three conditions
22 satisfied. If they weren't satisfied, you would expect that
23 it wouldn't really exert price discipline.

24 PROFESSOR SHAPIRO: Yes. I think you stated it
25 very clearly. I just wanted to doublecheck --

1 PROFESSOR VARIAN: Yes.

2 PROFESSOR SHAPIRO: -- what it would imply in the
3 case where we observed premerger price discrimination.
4 Okay.

5 Doug.

6 MR. ZONA: Hi. I'm Doug Zona, and I'm an
7 economist. I know that it's maligned sometimes. And I had
8 thought sometimes, that being an economist requires an
9 apology. I hadn't thought it would require one here, but
10 apparently it does.

11 So about, well, maybe five years ago I was meeting
12 with a CEO of the California Power Exchange. And we were
13 talking about the bad things that were happening there at
14 that point in time. And I walk into a conference room and
15 there is the CEO. He's sitting with his feet up on the
16 table. He's the only guy in there. I walk in and he goes,
17 "Who are you?" And I said, "Well, I'm an antitrust
18 economist." And he kind of leans back a minute and he says,
19 "Well, that doesn't help me. I don't trust any of you
20 people."

21 So, I would second a motion to change it from
22 "antitrust" to "trust." And maybe we should do the same
23 thing with price discrimination. It shouldn't be called
24 discrimination. It should be called "price opportunism," or
25 something that sounds a little bit better, because like

1 antitrust, it doesn't really mean that.

2 So price discrimination, here we are, my firm did
3 an analysis of the comments that were submitted for the 20
4 questions or so that were asked by the Agencies. And 20
5 questions, looking at the responses, there were about 40
6 written submissions to those questions.

7 The top three questions dealt with direct
8 competitive effects, the HHIs, and efficiencies. All of
9 those got at least 10, in one case 16 comments, about that
10 particular topic. Going down the list of all 20 questions,
11 price discrimination, it was 16, way at the bottom. And I
12 don't know why that is.

13 Price discrimination is very exciting for an
14 economist, and yet there were only six responses to that
15 particular question. I don't know why.

16 Large buyers, price discrimination, localized
17 competition, these are right at the nexus of the tension
18 between the market definition question and the competitive
19 effects question.

20 I think it makes good sense that the price
21 discrimination discussions that appear in the Guidelines are
22 where they are, because in a sense it's completely a market
23 definition question.

24 For a particular group of customers can you
25 profitably raise price to them? If you can't, that sounds a

1 lot like a guidelines market. So I think that it's properly
2 placed there.

3 I personally would like to see more emphasis in
4 the Guidelines on discussing these particular issues, not
5 because market definition is the thing to talk about but,
6 rather, because price discrimination, localized competition,
7 large-buyer questions are exactly the context in which you
8 can evaluate some of these competitive questions.

9 They provide the detail that you need to be able
10 to tell the story, and we are in the story business, after
11 all. So the things that I'd like to see looked at in the
12 Guidelines, the kind of questions I'd like to see addressed,
13 or issues teed up, or lists requested would be:

14 How can these particular buyers be identified?

15 Is it profitable to discriminate against them?

16 And the third kind of question is: Price
17 discrimination requires an apparatus to market to these
18 people, to enforce the prices, all that sort of stuff.

19 You might have tiered pricing. You might have
20 individual negotiations. There might be individual
21 negotiations with each customer. There's lots of different
22 ways that you can price discriminate, and they would involve
23 costs in terms of the marketing.

24 That's something that needs to be looked at, where
25 you have a single price for everyone; that's cheaper, a

1 single posted price, that'd be a cheap thing to do, as
2 opposed to individual negotiation with every customer
3 irrespective of their size. So those are the kinds of
4 questions you might ask on the supplier side.

5 There are questions on the buyer side. What
6 alternatives do they have? Self-supply is often a question
7 that comes up with large buyers. Do they have downstream
8 buyers so that a price increase might be passed through
9 easily, if everybody uses the same input, for example?
10 Those are the kinds of things you might look at on the buyer
11 side.

12 There are a whole host of structural factors that
13 you might want to consider as well, the kind that Kathleen
14 was talking about. For example, a coal-mining merger, where
15 do the tracks go? That's an important question, and it may
16 limit the alternatives that can be considered and what can
17 be substituted, or the land use kinds of restrictions that
18 may limit the things that can be considered.

19 So I think that posing it that way and looking at
20 competitive circumstances in a more narrow group of buyers
21 is often the way to go, a better way to go.

22 PROFESSOR SHAPIRO: Okay. Thank you, Doug.

23 Karen, if you would go next.

24 MS. SILVERMAN: Hi. I'm pleased to be here, as
25 already introduced, to speak sort of on behalf of the

1 practitioners and counselors. That said, I think a lot of
2 what's already been brought up on the economics is directly
3 relevant.

4 But what I want to address now is someone who's
5 going to have to live with and try to apply and explain
6 these new Guidelines or the revisions to them, assuming
7 there are some, sort of how we think about the Guidelines
8 and what makes sense.

9 I'm going to get a little bit descriptive. I
10 think my daughter would say probably bossy. But I have got
11 a couple ideas about what the revisions should do and
12 shouldn't do. Then we can talk about how the factors
13 substantively play out, because I think that is
14 fundamentally the more interesting question. We have got
15 the practical question of how do we render this into a set
16 of Guidelines that then get applied. I think, as
17 Commissioner Rosch mentioned, there is sort of a false sense
18 of certitude that can attach to the words that get into the
19 Guidelines. We need to avoid the risks of that in a couple
20 of different dimensions.

21 Yes, I agree, that the terse treatment of price
22 discrimination and the absence of discussion of large buyers
23 is probably worth addressing in any revision. The reality
24 is, it's a little bit like the old essential facilities
25 discussions where these are really concepts that are

1 extensions of principles that are already being applied and
2 already inherent and innate to the Guidelines and to
3 Guidelines analysis, but calling them out explicitly and
4 treating them more fully may well help.

5 It's with some trepidation that I recommend that
6 we start adding more words to the Guidelines, because I do
7 think the words take on a life of their own, and I do think
8 that there is a false sense of certainty that gets attached
9 to them on the one hand, or even overreliance.

10 We've talked about some of the government's
11 efforts to try these cases and the value of direct evidence;
12 we won't rehash all of that. But one of the concerns I have
13 as a practitioner is that that evidence has to be weighed
14 and evaluated and the skepticism that merging parties are
15 met with, whether they are arguing about efficiencies or new
16 entry ought to also be attached to a lot of the third
17 parties who come forward with sort of the market realities,
18 as they understand them, complaints about a transaction, and
19 so forth.

20 So all that evidence, excellent and important to
21 collect, but it all has to be looked at, whether from a
22 trial lawyer's perspective or just from an economist's
23 perspective on how robust, how viable, how credible, and how
24 probative. Something in the Guidelines that addresses the
25 effort to balance these features would be helpful.

1 What I personally think, the most powerful
2 Guidelines we have and the most utility that the Guidelines
3 can provide is to set out a framework, not a prescription.
4 I think every time the Guidelines try to be anything other
5 than neutral they inevitably get it wrong.

6 If there is one thing we have all learned -- and I
7 don't want to count, but it's more than 20 years that I have
8 been doing this -- is that no two mergers are really the
9 same. No two industries are really the same. Many
10 industries are not the same year to year, particularly in
11 the Valley and in technology-related industries.

12 So the most useful concept for the Guidelines are
13 to give us the factors, the tools, the variables, perhaps
14 put some weight on the credibility of those factors or the
15 utility of those factors, but to start telling us when
16 certain -- the large buyers are rarely going to overcome
17 market power or -- I think that is what the Commentary now
18 uses, where rarely would it be. I think that is
19 inappropriate. Frankly, I think it's just wrong, and I
20 don't think it's particularly helpful.

21 What we do as counselors, obviously, is take a
22 list of factors, apply them to our facts. All of these
23 mergers and the analysis come down to facts and often at a
24 very granular level. So we can apply the facts to those.
25 The Agencies can apply the facts to those variables. We'll

1 agree or we'll disagree on what the interpretation is, but
2 you don't really need to get too prescriptive in the
3 Guidelines.

4 So with those caveats I would say on the power
5 buyer questions -- and I do think of it more as a power
6 buyer set of questions than a large buyer set of questions,
7 because you can imagine large buyers -- it's already been
8 discussed -- don't necessarily have market power. Small
9 buyers don't necessarily not have power.

10 Sometimes the buyer power is a collection of
11 buyers. Sometimes it's an individual buyer. So there are a
12 lot of -- I think we tend to think of it in terms of power.
13 I think it does go, like the price discrimination questions,
14 really to what's constraining the merged parties' pricing.

15 Fundamentally we are talking about competitive
16 effects. I think not only looking at what constrains the
17 pricing of the merged entities and before the merger,
18 premerged firms, but whether the deal itself will have any
19 impact on that pricing behavior.

20 That drives you almost directly and immediately
21 into who are the customers, large or small, collections or
22 individually, power not power. What's the history? I think
23 that is an important feature to look at.

24 Assuming we have a set or an individual power
25 buyer in a marketplace, you can be sure that they are going

1 to push back against the merged firm to protect their own
2 interests.

3 We can discuss whether that is possible or not
4 possible, but the benefits and significance of that
5 collection of power buyers could very well extend indirectly
6 to other purchasers in the marketplace, as well. I think
7 the relevance of that inquiry could be brought out in a new
8 Guidelines.

9 It's important to understand what the range of
10 competitive responses is to smaller buyers, and what the
11 mechanisms -- I think Dr. Zona addressed it, as well -- the
12 mechanisms and the likelihood of success attached to the
13 ability to push back, or as the Europeans talk about it,
14 countervailing buyer power. All important and relevant.

15 The Guidelines could be improved, I think, by
16 accentuating the relevance of that inquiry. Interestingly,
17 it's only treated where the Guidelines attach to monopsony
18 mergers. The relevance of buyer power is discussed only in
19 that little section of the overview where monopsony power is
20 identified as being a proper subject of the Merger
21 Guidelines.

22 For all the same reasons that you could imagine
23 the Guidelines attaching to monopsony mergers, you can
24 imagine it being relevant to a monopoly merger, as well. It
25 seems inconsistent not to address that as a relevant

1 inquiry.

2 My own feeling is that the Guidelines ought to
3 neutralize the statements on whether power buyers are likely
4 or unlikely to countervail market power and just identify
5 that as an important inquiry.

6 I think a separate section on buyer power or price
7 discrimination probably is useful, just because it touches
8 on market definition, competitive effects, entry, and
9 efficiencies. It touches on the entire, you know, analysis.
10 I think putting it all in one place is probably a very
11 helpful thing to do.

12 On price discrimination, just real quickly,
13 because I know we'll talk a lot about it, I think the
14 important thing for price discrimination to really matter in
15 an anticompetitive way is that it has to be sufficiently
16 systemic. It has to be sufficiently accurate so that it's
17 profitable. All the facts that go into analyzing whether
18 it's going to be systemic or systematic and accurate and
19 sufficient to allow marginal customers to discipline the
20 merged entity, in a way that protects inframarginal
21 customers. It's all very fact-driven.

22 So, again, I would stay away from prescriptions
23 there. What the Guidelines ought to confirm is that we have
24 no lesser standard or abbreviated analysis in price
25 discrimination markets than we do in other kinds of markets.

1 There is no, I don't think, principled basis on
2 which we can skip over the competitive effects part of that
3 equation. Quite frankly, I think where that principle has
4 been abused in the market definition world, it's where it
5 tries to sort of bootstrap into narrow markets so that they
6 can sort of presuppose a competitive harm, and they cut
7 short the competitive effects analysis.

8 I think if the Guidelines make clear that even if
9 you are going to talk about it as a market definition rather
10 than competitive effects issue, at least we are talking
11 about the same fundamental analysis, which includes all the
12 competitive effects questions.

13 The Guidelines might well want to collapse those
14 two in the case of the price discrimination markets to say
15 in those sorts of markets where we think price
16 discrimination is possible we are going to collapse those
17 two inquiries, and there'll be no distinction between them.

18 I think two other things will be important to
19 focus on. One is that it is still the demand for the
20 product that drives the price discrimination question, not a
21 set of customer characteristics that might be described.

22 We had this issue in the *Oracle* case, and in
23 several others subsequent to it, which is you are still
24 talking about economic markets and lines of commerce that
25 need to be affected. The Guidelines, frankly, should just

1 address that. It's in the statute, and they ought to repeat
2 it.

3 So important variables that affect both buyer
4 power and price discrimination: Are the products
5 differentiated, or are they not differentiated? By the way,
6 I think by focusing on the products and the demand for
7 products you get to the same place as if you start with
8 customer characteristics. Where conditions warrant, looking
9 at price discrimination markets in smaller sets of
10 potentially vulnerable customers, like starting with the
11 product characteristics, you get to the same place.
12 Frankly, that is where we start from a practice perspective.

13 Are the products differentiated, or are they not?
14 If they are differentiated, how? So, for instance, in the
15 lab analysis suppose that those are very differentiated
16 buyers, but a very common product. You can imagine a
17 different set of economic realities than if, in fact, the
18 products themselves were highly differentiated and people
19 were buying them in some cases for resale and in some cases
20 for end use.

21 Are the products sole-sourced, or do the buyers,
22 these power buyers multi-source? I think in the
23 semiconductor area you see a very different set of pressures
24 because of this multi-sourcing practice. Is the product
25 something that is uniquely sold by the seller, or does the

1 seller supply a variety of products to these same buyers?
2 Is it a new product, or an old product? Is it subject to
3 these dynamic design cycles? Is it bid out, or negotiated,
4 or is it sold off lists? And, frankly, do the buyers like
5 the deal and why, and why don't they like the deal?

6 I think fundamentally -- I know we'll get into
7 some efficiencies questions that Carl wants to raise -- it's
8 not irrelevant that important buyers may support a
9 transaction and I don't think necessarily suspicious.

10 Anyway, two quick things. I think the Guidelines
11 should not try to define what a power buyer is with any kind
12 of mathematical equation or definition. I think that would
13 be an enormous distraction. I think they should step away
14 from this sort of predisposition to say that buyers can
15 rarely offset or overcome the exercise of market power. I
16 don't think that is true. I don't think we could possibly
17 know it. I don't think they should set a standard for
18 relevance of these features that equates or even borrows
19 from the timely, likely, and sufficient entry kind of
20 analysis. Sometimes you hear that. I think that far short
21 of that standard, you could see power buyers having a quite
22 substantial and predictable effect to protect markets more
23 generally.

24 I don't think you should require that all
25 consumers benefit from whatever disciplining effect the

1 power buyers may have, and we can discuss that. I don't
2 think that is the law. I don't think you can measure it,
3 and I don't think it'll matter in every case fundamentally.

4 Certainly, you should not presume anticompetitive
5 effects in a price discrimination market without having done
6 a fuller analysis. I don't think it really will serve us
7 well to try to define targeted consumers in great detail,
8 for the same reason as it's going to be hard to define power
9 buyers.

10 It's going to be very fact specific, and I think
11 ultimately misleading, and probably a false sense of
12 certainty around that. So I'll take a question, please.

13 PROFESSOR SHAPIRO: Well, thank you. There was a
14 lot there, and I have a feeling there is more that you
15 didn't get to.

16 Craig, let me ask -- I actually want to ask Karen
17 a question, too, before you go, so.

18 MS. SILVERMAN: I'll sit down.

19 PROFESSOR SHAPIRO: Sit down. Do a dance, or
20 whatever you're most comfortable with.

21 MS. SILVERMAN: That is not --

22 PROFESSOR SHAPIRO: Just a couple things, because
23 I think they seemed quite useful, and I want to clarify.
24 One thing you said, it seemed like the analysis of price
25 discrimination should be based on competitive effects. One

1 thing is to take the discussion of price discrimination and
2 have it not just be in the market definition section, right?
3 It could be a discussion of effects that has some of the
4 fundamental issues of price discrimination, when it can
5 happen, how we think about it, that would apply potentially
6 to both market definition and analysis of effect.

7 MS. SILVERMAN: I think that would be both useful
8 and more apt for the -- and I think it would give the
9 Agencies and private parties an opportunity to really
10 explore, exhibit the sort of symmetry in the analysis, which
11 I think right now is subject to misapplication.

12 PROFESSOR SHAPIRO: Okay. The other question -- I
13 guess, actually, you also mentioned another case that might
14 be useful to throw into the mix. You mentioned in some
15 cases the same product with different prices and other cases
16 different products.

17 Back in 2000 the DOJ challenged the
18 Ingersoll-Dresser Flowserve merger, which is industrial
19 pumps. The pumps were customized for customers. And we
20 were basically concerned about pumps used in oil refineries
21 and electric power plants. Since they were customized and,
22 in fact, the DOJ said each procurement was a separate
23 market, because the customer would need this pump. It would
24 be customized. There'd be some bidding, and you could look
25 at it that way. That might be another example to have in

1 mind.

2 While it seems like this Quest example with the
3 labs is the same product, as far as I know, pretty much the
4 same product. We'll take that as our stylized fact. Sold
5 to different customers. So would that be a situation where
6 you would be comfortable going to customer-specific markets
7 or, let's say, markets for industrial pumps sold to electric
8 power plants as a market, or are you uneasy with that?

9 MS. SILVERMAN: I'm uneasy stopping there. I
10 think it raises an interesting question, but then you have
11 to look at the supply conditions. One of the reasons I
12 mentioned semiconductors -- and there are undoubtedly people
13 in the room here who know more about it than I do -- is that
14 because there is so much multi-sourcing that occurs and so
15 much self-supply that occurs, there are capacity
16 opportunities and resale opportunities. You want to look at
17 all those kind of repositioning questions.

18 PROFESSOR SHAPIRO: Um-hum.

19 MS. SILVERMAN: You want to look at the reserve
20 capacity questions. The margin questions. I mean I don't
21 think you can stop the analysis, but at least under the
22 facts that you just mentioned, asking the next question
23 becomes interesting and relevant.

24 PROFESSOR SHAPIRO: So that seems to relate,
25 Karen, to your saying we should be very careful and there

1 shouldn't be presumption in the customer-oriented market.

2 So is that because --

3 MS. SILVERMAN: I think --

4 PROFESSOR SHAPIRO: In general, we know the
5 structural presumption has declined over time.

6 MS. SILVERMAN: Right.

7 PROFESSOR SHAPIRO: And maybe you are saying that
8 it should be even more carefully applied, if at all, in
9 these type of markets because there is more likely to be
10 some sort of supply-side substitution that somebody who's
11 good at selling pumps to a different category of customers
12 might easily shift and supply them to --

13 MS. SILVERMAN: Right, because if it --

14 PROFESSOR SHAPIRO: -- electric power plants?

15 MS. SILVERMAN: -- four more knobs that need to be
16 turned, and that is what you need to get into that
17 business, --

18 PROFESSOR SHAPIRO: Right.

19 MS. SILVERMAN: -- and if it's attractive, that is
20 a different outcome --

21 PROFESSOR SHAPIRO: Okay.

22 MS. SILVERMAN: -- than you need to restructure
23 the --

24 PROFESSOR SHAPIRO: No. I agree that that could
25 be captured under the so-called uncommitted entry or some

1 other sort of supply side.

2 MS. SILVERMAN: But I think the discussion ought
3 to all be in one --

4 PROFESSOR SHAPIRO: Yes.

5 MS. SILVERMAN: -- place, because I think the
6 tendency has been is that if we can sit there -- if we can
7 define a category of vulnerable customers because they are
8 uniquely sort of inframarginal, then we can start assuming
9 all the competitive effects and therefore bad.

10 I think that is where we get off track with this.
11 I think if you can back it up and say, no, no, no. You can
12 collapse the analysis, but you have to go through the whole
13 thing.

14 PROFESSOR SHAPIRO: Okay. So if --

15 MS. SILVERMAN: Then you are bringing in the
16 uncommitted entrants, and other factors, and...

17 PROFESSOR SHAPIRO: And that seems to touch a
18 bigger theme, which I think is a pretty wide consensus
19 ultimately when trying to do competitive effects, you have
20 to be careful about any one slice of it if you don't look at
21 the other pieces and take --

22 MS. SILVERMAN: I think it's a particular problem
23 when we start talking about price discrimination markets, --

24 PROFESSOR SHAPIRO: Okay.

25 MS. SILVERMAN: -- though, partly because of how

1 they have been applied and just partly because the treatment
2 is so uneven in the Guidelines.

3 PROFESSOR SHAPIRO: Okay. You've been patient,
4 Craig. Please, do your thing.

5 Thank you, Karen.

6 MR. WALDMAN: Thanks, Carl.

7 And Carl and Joe and Greg and others should be
8 really commended. This is a large undertaking, and I think
9 very worthwhile to revisit the Guidelines every now and then
10 to make sure it's what we should be doing collectively as a
11 Bar, and also that it actually reflects Agency practice. So
12 I really thank them for all their efforts.

13 I share a lot of Karen's thoughts, as well, which
14 is having worked together as many times as we have, I'm not
15 entirely shocked that we come out similarly on some of these
16 things.

17 The way I think about the Guidelines and this
18 question is: Does price discrimination occur in the
19 practice of the Agencies? Does it happen often enough that
20 we should care about it, and are the Guidelines adequate in
21 the way that they address them? That's sort of the way I
22 conceptualize that.

23 I think especially in a lot of the technology
24 markets that I deal in pretty frequently these issues come
25 up all the time, constantly come up all the time. When we

1 get a call from a Staff attorney who is indicating that they
2 have some ongoing concerns, hopefully, if I'm doing my job
3 it's pre second request, but maybe post second request, I'll
4 find out a little bit more about what their theory is.
5 They'll say one of two things.

6 They'll say: We are concerned that yes, you are
7 in a market of five players, but there is a pocket -- it's
8 usually my word -- but there is a pocket of consumers that
9 we think the merging parties can target and price
10 discriminate against, and that is where the localized effect
11 is going to be, or you'll get a different Staff attorney to
12 say: We think this is a market built around the price
13 discrimination theory. That is, a market, it merged into a
14 monopoly, but the market is itself a price discrimination
15 market.

16 Maybe the economists would tell me if I'm wrong,
17 but I'm not sure in practical terms, in terms of my problem
18 in getting that deal through, whether there is a major
19 difference between the two.

20 Either way, I have got to convince them that there
21 are alternatives to be found to that particular problem. I
22 think because of the frequency with which it comes up and
23 the fact that I do think the Guidelines are short on the
24 issue, I do think it needs some amplification on what is
25 actually happening and how.

1 I have no beef with the concept. I think the
2 theory is perfectly plausible. I was in the FTC and it made
3 sense then, and I think it makes sense now.

4 My challenge over time with the Staff at various
5 points and times has been, when they say: Look, we think
6 you can identify somebody, we think you can target somebody,
7 and we don't think you can arbitrage. Those are the sort of
8 three pillars of the price discrimination theory. I think
9 the arbitrage one is kind of swept away because most people
10 don't see a lot of bartering among technology companies,
11 because there is customization of products or because there
12 may be an extra margin that is going on in that resale, et
13 cetera. So let's sort of set that aside for the moment.

14 I think the place that I think the Agencies could
15 be a little crisper on is how we, as merging parties, know
16 that that set of customers is somehow beholden to those
17 products. It's one thing for a staff attorney to speak to
18 the person in an interview, that is a confidential
19 interview, and identify them and say: Well, we are really
20 sort of wed to these products, or we are wed to these
21 suppliers, or et cetera, perfectly understandable concern.

22 I think where when we have pushed Staff to give us
23 a little bit of articulation of how is it that the merging
24 parties know that, sometimes that has been proven in our
25 documents and sometimes it's not, but it's a very tough

1 issue to get your hands around.

2 I think the price discrimination theory falls
3 apart rather quickly if you guess wrong a couple of times,
4 because it has to really be a pretty accurate theory in and
5 of itself. What that has led to in my experience has been a
6 real strong reliance on win/loss reports, CRM databases,
7 discussions of who you think you are competing against and
8 why. Those are sort of the juiciest documents that end up
9 being part of this theory.

10 Again, I don't see anything particularly wrong
11 with that. That's perfectly plausible evidence, but I do
12 think because of that there should be a bit of an expansion
13 in the discussions in terms of what we as counsel are aiming
14 at. I personally think it should be both in the market
15 section and the effects section. Obviously, it's not a big
16 surprise, based on what I'm saying. I think Pam mentioned
17 the coordinated effects theory issue earlier on in her
18 question. I think at some point, as Commissioner Rosch
19 said, it's really all about a competitive story at the end
20 of the day, whether you are saying, I have a price
21 discrimination market and the question is whether other
22 companies can reposition themselves to defeat that price
23 discrimination, or whether you are saying companies don't
24 have the incentive to take share; they've got to follow
25 along with the price increase. That sounds more like a

1 coordinated effects theory; it sort of ends up in the same
2 point at the end of the day.

3 I think inevitably the Guidelines need to deal
4 with price discrimination as an element of coordinated
5 effects, or at least address that it's not relevant there if
6 that is, indeed, what people think.

7 On the large buyer piece, I guess I would say
8 there in the practical reality, as I think of appearing
9 before the Agencies, clients always pound the table about
10 large buyers, and you would like to tell them: If that is
11 the first thing you say at the meeting with the Staff you
12 are going to be in trouble, right. Start with product
13 market. Start with anything else other than saying these
14 guys can protect themselves. But the reality is, it is
15 often the case. Even if they are ten percent of the buyer
16 market, you talk to the business people and they say: Look,
17 I have been mining this relationship for seven years; am I
18 really going to risk that? They buy 20 other products from
19 us, and it's just not in the real world that I'm going to
20 try to raise prices to them.

21 I think that practical commentary by our client in
22 a company has to translate into some useful mechanism in the
23 Guidelines if, in fact, that is where the Agencies are with
24 that. But I recognize also, the challenge of the
25 large-buyer argument, of course, is that if you argue large

1 buyers and your large buyers are behind the scenes
2 complaining, that is worse because then you are saying even
3 your large buyers can't protect themselves. And then you
4 have to worry about price discrimination.

5 So I do think these are two separate issues, Carl.
6 But I see the large buyer and the price discrimination issue
7 as sort of inextricably linked and probably should be dealt
8 with at the same time.

9 I'm sure we have other issues to address as we
10 take your questions, but those are my takes on the current
11 Guidelines.

12 PROFESSOR SHAPIRO: Thanks so much, Craig. Let me
13 have a little follow-up question for you, as well. I think
14 you brought it along nicely how a Staff attorney might call
15 you and say: We are worried about this pocket of customers'
16 as you put it. And then you would say: Well, okay, maybe
17 those guys, those customers have turned to the merging
18 parties' products disproportionately a lot, but how do you
19 know they are wedded to them, particularly couldn't switch
20 to other stuff just because they have done that.

21 So that gets me to this question about accuracy,
22 if you imagine targeting these guys by the merged entity.
23 What happens next, then, can we say something that -- we
24 could say in order to price discriminate profitably it would
25 have to be profitable to target these guys and then, well,

1 it depends on how accurate you are in figuring out these
2 other guys who have a low elasticity or can't substitute.
3 Can you say any more about how that works in practice, or
4 what we might say about it?

5 MR. WALDMAN: Yes. It's a hard question.
6 Frankly, I think with *Whole Foods*, the D.C. Circuit sort of
7 stopped short of actually worrying about that, because they
8 said there are inframarginal customers, but they never
9 really went to the level of saying how do I target them. So
10 I think it's not only a Guidelines question, it's a case law
11 question.

12 I don't have a number for you. I don't say you
13 need to have a batting average of 400, or 600, or whatever,
14 but that is where the smarter economists can come in and
15 tell us what the --

16 PROFESSOR SHAPIRO: No, no, no. Tom has taught
17 us, no numbers here. You can't do that.

18 (Laughter.)

19 MR. WALDMAN: I think it's a tough question
20 because you are looking prophylactically at what is going to
21 happen postdeal. It's not --

22 PROFESSOR SHAPIRO: Yes.

23 MR. WALDMAN: -- and I don't know. Some clients
24 joke when you explain the theory to them of what the
25 Government is. I wish I knew that six months ago. I would

1 have probably priced it a little bit differently if I knew
2 they were so wed to my products.

3 I don't have a good answer, honestly. I certainly
4 think there should be an articulation that pushes Staff a
5 little bit further to show that they think an accurate price
6 discrimination strategy is credible.

7 Unfortunately, I don't have a really good answer,
8 other than suggesting that in my view a couple of misses
9 probably is not enough to say it, but if you really can't
10 accurately gauge who's going to buy for what and for what
11 reason, it's not much of a price discrimination theory.

12 PROFESSOR SHAPIRO: So, one way to go would be to
13 say, well, this has to be identifiable by the merged entity
14 if you are talking about competitive effect, or the
15 hypothetical monopolist if you are talking about market
16 definition. And that, based on information that would be
17 available to them, which is different than the information
18 that our Staff may see, okay.

19 MR. WALDMAN: Right.

20 PROFESSOR SHAPIRO: I mean so that is I think part
21 of the point. So that kind of description --

22 MS. SILVERMAN: It --

23 PROFESSOR SHAPIRO: Maybe I'll open this up to the
24 whole panel now in terms of the conditions necessary in
25 practice to have profitably engaged in price discrimination.

1 Karen, you look like you --

2 MS. SILVERMAN: There is another information
3 problem, which is that when you are talking about negotiated
4 markets or bid circumstances, the buyer controls how much
5 information in many respects the seller is going to get.
6 It's about how many people compete for a particular order or
7 how committed they are. So not only do you have to be
8 correct about which of your adherents, but you have to be
9 correct about where their paying points are. There is a lot
10 that has to be right in an environment.

11 I think the Guidelines could usefully tease out
12 where it's in everybody's interest to give misinformation
13 back and forth, where sellers are posturing, well, I don't
14 really need this. And I've got seven more people lined up
15 behind you, and you better get competitive, versus --

16 PROFESSOR SHAPIRO: The buyers are posturing.

17 MS. SILVERMAN: And buyers are posturing. I'm
18 sorry.

19 PROFESSOR SHAPIRO: Yes.

20 MS. SILVERMAN: You can imagine it in both
21 directions, actually. I think you have to be careful about
22 -- and this is sort of what I was alluding to in the direct
23 evidence question -- you have to be real careful about not
24 just the quality, but the context in which some of this
25 information comes out. That is setting aside the imbalance

1 of information, again, -- and Craig alluded to this -- as
2 between the parties and the agencies who, you know, may have
3 a much broader market.

4 PROFESSOR SHAPIRO: Let's take the industrial pump
5 example, say. So there I could imagine -- I'm not talking
6 about those companies or that case, but just more
7 conceptually, -- the merged company or the merging firms,
8 they have pretty much found over time that they are often
9 going up against each other for the pumps sold to oil
10 refinery, say, and, yes, some other companies make pumps,
11 but they don't appear that often. And they know who's an
12 oil refinery and who's some other completely type of use.

13 So then would there be any objection -- I mean it
14 seems correct to be asking for that well-defined, reasonably
15 well-defined class of customer, maybe very well-defined,
16 would a targeted price increase seem possible, based on the
17 information they would plausibly have?

18 MR. WALDMAN: Yes. I mean, I think -- I'm sorry.
19 Were you directing --

20 PROFESSOR SHAPIRO: No. Go ahead, please.

21 MR. WALDMAN: I would look -- in fairness to the
22 Agencies, --

23 PROFESSOR SHAPIRO: Please.

24 MR. WALDMAN: -- in fairness to the Agencies, I
25 think there are situations where you can identify evidence

1 that suggests that the companies know to whom their
2 customers can turn to.

3 PROFESSOR SHAPIRO: Yes.

4 MR. WALDMAN: I think that is reflected in --
5 sometimes in the amount of times people are reflected in
6 CRMs, as I mentioned, --

7 PROFESSOR SHAPIRO: Yes.

8 MR. WALDMAN: -- the databases and things like
9 that. I think it comes up a lot also when the merging
10 parties argue that the customers can make the product
11 themselves, that they can vertically integrate. There's
12 reflections in documents sometimes that say, we know -- I
13 have seen this before -- we know; we are bidding on this
14 thing. It's a six-month project, a six-month RFP, there is
15 a BAFO. They are going to say that they are going to make
16 it themselves if we don't drop prices and if we don't take
17 that seriously. And we have literally seen those kinds of
18 documents.

19 MS. SILVERMAN: You know --

20 MR. WALDMAN: But that is the kind of document --
21 sorry, Karen -- that is the kind of evidentiary basics that
22 I think is juicy for a Staff attorney and probably somewhat
23 required at least for the theory to hold up.

24 PROFESSOR SHAPIRO: And it seems to me this could
25 apply whatever dimension the price discrimination. You were

1 talking about categories of customers. It could be
2 geography-type use, purchase history in some of the tricky
3 cases where there is a lot of knowledge that sellers have
4 based on the buyer's purchase history. Investments they
5 have made, --

6 MR. WALDMAN: Um-hum.

7 PROFESSOR SHAPIRO: -- training, whatever.

8 MR. WALDMAN: Um-hum.

9 PROFESSOR SHAPIRO: And there it seems like it
10 would be pretty plausible you could have quite targeted,
11 even individualized, price effects. And that presents a
12 puzzle for the Agencies in that one is inclined, the
13 economists especially, probably, maybe to say they are a
14 customer-specific market. This customer is not only -- or
15 at least these types of customers, right now they are fine,
16 but that seems like it has some difficulties often when the
17 lawyers are less comfortable, probably for very good
18 reasons. You're grimacing --

19 MS. SILVERMAN: Yes, I think you are right. I
20 think you could run into your --

21 PROFESSOR SHAPIRO: -- you are grimacing --

22 MS. SILVERMAN: I'm sure that's right. I think
23 you run into your line of commerce problems there, which is
24 that it would be -- for a merger that otherwise creates
25 efficiencies for power buyers and others, if you identified

1 one customer who is not going to be able to defend him or
2 herself against, you know, the merged entities' new magic --
3 I'm not sure that either is a legal or -- and I don't think
4 a law supports that.

5 PROFESSOR SHAPIRO: Yes. And I --

6 MS. SILVERMAN: And it would be some very rare
7 circumstances.

8 PROFESSOR SHAPIRO: No. Like if it's the Defense
9 Department is the one customer, we get that. But if it --
10 you know, it's two customers and they are a lot more, that
11 could be too narrow to be significant under Section 7, you
12 would think.

13 But what about the alternative, saying there are
14 actually quite a few customers we think are vulnerable.
15 It's going to be done on a customer-by-customer basis, the
16 pricing.

17 And so we think the effects are significant in a
18 broader group, but not uniform.

19 Doug, you look like you are ready to go.

20 MR. ZONA: In my experience, I have actually
21 worked with customer-specific markets particularly in the
22 procurement setting. While the market definition comes back
23 to us as a principle in the Guidelines or Guidelines
24 markets, there are other ways to define markets, but under
25 Guidelines structure it's customer-driven -- it's

1 demand-driven, the market definition part.

2 So you may well have a series of markets, all
3 separate, but the competitive circumstances are identical or
4 they are very similar across different, say, locations. In
5 the particular context I'm thinking of, it was school milk.
6 The competitive circumstances were different, somewhat
7 different, as you moved up through the geography. Still
8 because the proximity of the various suppliers were a little
9 bit different, but each of those school districts, each of
10 the counties, each of the buying was a separate negotiation.
11 There are separate people who are qualified for the
12 particular thing.

13 In lots of auction settings there is often a
14 prebid phase or a qualification phase that can take years to
15 go through for some high-tech products. So all that stuff
16 is controlled by the buyer, not by the merging parties in
17 each context.

18 I wouldn't be so alarmed by a list that has two
19 buyers in the past when that is all that they were looking
20 for. I have done a bunch of work for Phillip Morris, and
21 they looked for three buyers. They want three buyers. They
22 won't have more. They'll have three or fewer.

23 PROFESSOR SHAPIRO: Three suppliers, did you mean?
24 What did --

25 MR. ZONA: Yes, that right. I'm sorry. Three

1 suppliers. Excuse me.

2 PROFESSOR SHAPIRO: Okay.

3 MR. ZONA: Thank you.

4 PROFESSOR VARIAN: Three buyers who probably
5 wouldn't know a good cigarette.

6 (Laughter.)

7 MR. ZONA: Very good.

8 MR. WALDMAN: Hopefully, we are heading that way.

9 PROFESSOR SHAPIRO: Before we move on from sort of
10 feasibility and contours of price discrimination, just some
11 other questions. One of the issues that comes up is when
12 the customers themselves compete downstream. They are
13 selling to a bunch of retailers, maybe big, small, or some
14 who seem like they really want the product or immediate
15 goods generally.

16 And the argument is sometimes made, well, you
17 can't feasibly, profitably price discriminate against one
18 group, because if you charge too much for them they will be
19 disadvantaged vis-à-vis their competitors, and that will
20 undermine price discrimination. Comments on that come up
21 fairly often, I would say. Is that worth addressing, saying
22 something about the conditions under what we would look for
23 to test that argument?

24 Hal, you might have an answer so, please.

25 PROFESSOR VARIAN: Yes. I don't know if I have an

1 answer, but at least I have some thoughts. I would say you
2 would want to look at what is the differentiation in these
3 downstream markets. So, for example, why don't we buy
4 everything at Wal-Mart, because they are the cheapest
5 supplier?

6 Well, there are lots of reasons. There is
7 convenience. There are different sets of products. There
8 are many other factors. So you would need to look at the
9 structure of the downstream market and see how competitive
10 it really is in a classic sense.

11 PROFESSOR SHAPIRO: And if we saw pre-existing
12 price discrimination across the different downstream firms,
13 that seems like it might suggest that it is profitable to do
14 that, notwithstanding downstream competition?

15 PROFESSOR VARIAN: Well, right. And to me it
16 would also suggest what is the source of that price
17 discrimination. There has got to be some sort of
18 differentiation that is going on in those downstream markets
19 to support that.

20 PROFESSOR SHAPIRO: Okay. That's good. Let's
21 see.

22 Let me move us forward a little bit. And there
23 are two, well, there are three or four questions from our
24 questions that we posed to the public that are relevant
25 here.

1 One we have already addressed, I think, which is,
2 is it worth elaborating on the two paragraphs in the
3 Guidelines on price discrimination. And I'm hearing general
4 assent, if we do it wisely, at least, and don't screw it up.

5

6 Let's talk about the geographic aspect of it. I
7 would say most of the cases where we are defining relevant
8 geographic markets it's based on customers located in
9 certain areas who would be vulnerable rather than based on
10 the location of the producers.

11 The Guidelines start at least with locations of
12 producers. This is question number six from our public
13 line:

14 Should the Guidelines be revised to state that
15 geographic market may be defined based on the locations of
16 customers, rather than or in addition to the locations of
17 suppliers, depending on circumstances.

18 The Guidelines do provide for that, but it's kind
19 of in an oblique way and secondary way. So your school milk
20 example is maybe one that fits that. Perhaps others have
21 thoughts on that premise.

22 PROFESSOR VARIAN: Well, the two examples we have
23 talked about here. One is there are very different
24 requirements in different geographic areas. So that was the
25 textbook example that was brought up earlier, so it may

1 affect entry.

2 And then the other issue would be,, what are the
3 real transportation costs historically and potentially,
4 because there is an impact there in terms of what potential
5 competition could look like if we adopted some new
6 technologies, irradiated milk, and that kind of thing.

7 PROFESSOR SHAPIRO: So here's an approach that
8 makes sense to me, at least. Take the textbook supplier
9 case where the State of California, I guess, that has
10 particular, hopefully, very wise, requirements for the
11 textbook, and maybe have a merger between two companies who
12 supplied a lot of textbooks in some category to California,
13 but they have much smaller shares in Texas or there are
14 other states, okay. And what would we make of those large
15 shares selling to California?

16 They are presumably -- if we define the market as
17 textbooks just sold to California schools or students in
18 California schools, we would count, in measuring shares,
19 sales for wherever the textbook happened to be printed or
20 wherever the publisher resided. That would not matter.

21 So we would just define the geography based on the
22 customer so we wouldn't have to worry about the locations of
23 the suppliers? Is that --

24 MS. SILVERMAN: But I think you would want to look
25 at the demand, where does the demand arise. It's not even

1 so much the definition of the customer. It's that these are
2 California-driven sales. So you start from that
3 perspective, and so you get to the same place, but you are
4 not starting with the customer. You're starting with the
5 demand.

6 PROFESSOR SHAPIRO: Okay.

7 MS. SILVERMAN: And that is a --

8 PROFESSOR SHAPIRO: Hal?

9 PROFESSOR VARIAN: And one of other cases you
10 could contrast this to is the example Kathleen mentioned
11 this morning about California having a unique gasoline mix.
12 So then we have got this question of, yes, there is this
13 specific set of consumers that have very specific
14 requirements, and what are the markets that can supply that.

15 Of course, there would be other ways to deal with
16 this by allowing importation of noncompliant gasoline if
17 there were certain supply conditions met, et cetera. So
18 there is a case where the transportation costs and what the
19 substitutes really look like is pretty critically important.

20 PROFESSOR SHAPIRO: Well, let me ask -- one of the
21 issues, then, if think about geographic markets. I know
22 it's not the most natural thing for a lot of high-tech
23 products, but the geographic market, whether it's the
24 textbooks or some other product that has transportation
25 costs, let's say, let's go with the textbooks, just because

1 we have it on the table now.

2 So you measure shares plausibly by sales into
3 California. Of course, you would have to consider the ease
4 of entry of somebody who could modify their textbook that is
5 not for California so it's suitable for California.
6 Definitely an important issue. That could even come under
7 uncommitted entrants, for example, because it's easy to do
8 quickly.

9 Now maybe I'm thinking more in physical products.
10 Sometimes the question, then, what about companies that are
11 outside, that sell a little bit into the relevant geographic
12 market. The textbook doesn't work for this, but more of a
13 industrial commodity. And they are kind of at a
14 disadvantage because they are produced far away. They ship
15 a little bit in to these customers. And then there is a
16 debate about whether they should be measured based on their
17 sales which might be small, or based on their capacity which
18 might be much larger and it is used for other customers in
19 other geographies.

20 This is a nontrivial example of a case at least
21 for DOJ where we do a lot of these, sort of manufacturing
22 industries. Comments on that issue, recognizing that
23 whatever we do with measuring the shares, of course, we
24 don't want to go too -- we don't want to put excessive
25 weight on the shares, but we do have to do it. This too

1 much of a steel industry question for Stanford, for Silicon
2 Valley?

3 MR. WALDMAN: I think it's something that comes up
4 often, which you would think about addressing, is
5 reputational issues outside the country. There are often
6 technology markets where the Asian communities have a pretty
7 strong presence locally, but they are not selling into the
8 U.S. And you ask the question, well, if the price increased
9 here, they are selling -- they are on the fringe. They have
10 got a single-digit share, or something like that, if the
11 merging parties tried to increase price that would naturally
12 invite some of the Asian competitors in more fully.

13 And, you know, sometimes that is compelling and
14 sometimes, frankly, it's not, either because they feel wed
15 to the, e.g., Japanese market, or because people will say,
16 well, I'll take a test run with that company, but I'm not
17 going to shift my entire purchase schedule from the merging
18 parties to them. And that is not enough of a disciplinary
19 force. I actually do think it occurs sometimes in
20 technology markets.

21 PROFESSOR VARIAN: Yes. I would say that one
22 question is: Well, why does this potential entrant or
23 potential firm that could increase its supply significantly,
24 why does it have a small market share now? Is it for the
25 reasons you described, that the company is worried about

1 multi-sourcing, or is it because the product isn't exactly
2 right for the domestic market, et cetera, et cetera? So you
3 would have to look at the facts with respect to what
4 explains the current situation.

5 PROFESSOR SHAPIRO: And that might be the
6 reputation qualification.

7 PROFESSOR VARIAN: Absolutely.

8 PROFESSOR SHAPIRO: It could be their capacity is
9 utilized somewhere else profitably, but the Guidelines would
10 recognize that.

11 Doug, you had a point?

12 MR. ZONA: I think that this comes up all the time
13 where there is a significant foreign capacity, mergers like
14 that, where there is something produced offshore.

15 But it also highlights why we shouldn't be doing
16 this. The answer to the questions are competitive ones.

17 Why doesn't this Asian producer count? Does
18 their capacity count fully? Do their sales count more, then
19 it doesn't fully reflect their competitive significance?

20 The answers to those questions have to do with
21 individual circumstances and how they are perceived by
22 buyers -- it's kind of the guts, the context of the story
23 that you are trying to tell. It's a competitive story, not
24 a market definition kind of thing.

25 PROFESSOR SHAPIRO: Well, if we take that example,

1 the one with the targeted customer, the certain-type
2 example, I think the Guidelines basically say this, but
3 maybe not as best they could -- if we are going to get into
4 the business of measuring shares, which we are going to do
5 to some degree, we want to measure shares based on the
6 competitive significance in the relevant market, which could
7 be geography to sell to these customers, and then we want to
8 somehow account for the ability to expand.

9 So one could emphasize that and how it's done in
10 price discrimination markets in general, without being
11 prescriptive, you know, that could apply general principles.

12 Karen, you --

13 MS. SILVERMAN: Well, I'm also thinking that there
14 are other dimensions, like duration, that you would want to
15 count, too. If you are looking for the discount factors off
16 share, I mean, whether it's technology or textbooks, I mean,
17 you need to look at the buying cycles.

18 The different industries that we have already
19 talked about today have very different profiles in terms of
20 the competitive significance, again, of these purchasing
21 decisions and the sort of durability of them.

22 It seems to me that would be very relevant. If
23 you are looking at geography and other dimensions, I would
24 look at duration as a dimension, too, that could either
25 discount or diminish the significance of a share that you

1 could measure yesterday.

2 MR. WALDMAN: You know what else, it does come
3 back to large buyers again, because I think the one area
4 where they are more of a compelling influence is in
5 sponsoring entry or at least threatening to sponsor entry,
6 or bringing -- maybe it's not officially entry. Maybe they
7 only have one percent, but bringing them up to speed in a
8 way that is more of a competitive threat.

9 So I think in your situation if there is somebody
10 who is offshore and somebody's going to attempt to try to
11 raise prices to the local customers, if a large customer can
12 turn to them and say, well, you can go ahead and try to do
13 that, but we are going to shift things over to this company,
14 they don't have to do it. They have got to be threatened to
15 do it, right?

16 PROFESSOR SHAPIRO: Take retail or various
17 industries such as retail that have seen consolidation. So
18 that argument, one could test it. One should presumably
19 test it and say, well, has that happened in the past where
20 they have moved a lot of business offshore, or is there some
21 problem, like you said, well, they are not really sure about
22 the quality of the products they would get from offshore.
23 And they might only do it gradually.

24 MS. SILVERMAN: I have seen circumstances where a
25 customer has threatened to skip a cycle, just: We are going

1 to sit this out.

2 PROFESSOR SHAPIRO: In terms of where there are
3 product improvements? Is that what you mean by a cycle?

4 MS. SILVERMAN: Yes. We're going to go stick with
5 this policy, and we'll just skip you next time. Maybe we'll
6 come back to you next time, the one after that.

7 PROFESSOR SHAPIRO: And buy it from somebody else
8 or some other facility?

9 MS. SILVERMAN: Buy it from somebody else, or
10 defer a purchase, or whatever, whatever it is. That is why
11 I keep coming back to it is so factually specific. And you
12 have to look at the quality of information and the
13 credibility of that information. Is the threat real? Is
14 it --

15 MR. WALDMAN: The interesting thing about Karen's
16 -- sorry, Carl.

17 That has come up in some technology situations.
18 It happened in software in particular. They said, well,
19 there is a next round every six, eight months, 12 months,
20 whatever. We'll skip this next version.

21 Some Staff attorneys have said -- and it's an
22 interesting debate -- well, that is a potentially
23 competitive effect in and of itself. The customer shouldn't
24 have to skip generations to try to protect themselves. That
25 is an effect.

1 So it kind of comes back a little bit to this
2 morning's discussion as to what is an effect and what is
3 not. I just want to throw that in because I think it's the
4 threat that matters that keeps people disciplined. But if
5 they are stuck skipping a cycle some in the Agencies have
6 said that that should be an effect in and of itself.

7 MR. ZONA: I have been in in a procurement kind of
8 situation where you get a contract, a couple-year contract,
9 and the buyer will say -- they will take a look. They'll
10 put their feelers out, look at the market and say: Well, I
11 don't think it's worth it for us to put this out to market
12 again. We are just going to negotiate a little bit on our
13 contract and extend it.

14 So they are making a decision to skip the market,
15 so to speak, for a moment and come back later, but they are
16 still getting lots of competitive benefits in terms of just
17 having that be out there, even though they don't
18 participate.

19 PROFESSOR SHAPIRO: Well, this is actually an
20 example where the Guidelines betray their history in
21 industrial manufacturing. They just talk about durable
22 goods, but software is pretty durable. Now, of course, the
23 main thing is it's improving and that gets us to nonprice
24 dimensions of competition again, which I think goes to your
25 question about what do we make of it if they defer.

1 Presumably, it's the threat. The threat's enough, then --

2 MR. ZONA: Right.

3 PROFESSOR SHAPIRO: -- we are good, yes.

4 Let me move this over more specifically to the
5 large buyers. It's come up a couple times. A number of you
6 have mentioned it already.

7 Let me read for everybody a passage from the 2006
8 Commentary to see whether people will say, oh, that is
9 great, you should put that in the Guidelines or, oh, my God,
10 it's no good. Don't do that.

11 So here it is. "In assessing the merger between
12 rival sellers, the Agencies consider whether buyers are
13 likely able to defeat any attempts by sellers after the
14 merger to exercise market power. Large buyers rarely can" -
15 - yes, rarely, Karen. You noticed that.

16 MS. SILVERMAN: Right. You know where I come out
17 on that one.

18 PROFESSOR SHAPIRO: Yes. You are on record on
19 this. Okay.

20 "Large buyers rarely can negate the likelihood
21 that an otherwise anticompetitive merger between sellers
22 would harm at least some buyers. Most markets with large
23 buyers also have other buyers against which market power can
24 be exercised, even if some large buyers could protect
25 themselves. Moreover, even very large buyers may be unable

1 to thwart the exercise of market power."

2 And, Craig, you mentioned this in terms of, we
3 have really got to look at the business reality of what we
4 are seeing. If one could describe the circumstances and
5 things one would look at to determine whether the large
6 buyers could protect themselves and/or others. So, could
7 one work with this and add to it in a descriptive, perhaps,
8 rather than postscriptive way? Reactions?

9 PROFESSOR VARIAN: I'll just say that to me it's
10 just an assertion. It's not saying why or what the --

11 PROFESSOR SHAPIRO: That's the beauty of
12 Guidelines.

13 (Laughter.)

14 PROFESSOR VARIAN: -- are. But, it seems to me
15 there are some instances or situations where why is it that
16 these firms can't rarely negate the exercise of market
17 power.

18 PROFESSOR SHAPIRO: The why. Okay. Why, then,
19 would lead into, presumably, the types of things we would
20 look for to test claims that large buyers would save the
21 day, so to speak.

22 Karen, your...?

23 MS. SILVERMAN: Well, if I were rewriting this, I
24 guess I would start with the proposition that it is possible
25 under some circumstances that they could or they couldn't,

1 if you wanted to put your bias out or not, but -- not your
2 personal bias, but I'm just saying, a bias into the
3 Guideline. You could say it is possible because of the
4 things we look at to determine whether it's true or not. I
5 don't know that rarely is it meaningful or useful term in
6 its --

7 PROFESSOR SHAPIRO: So let's set that aside. I
8 don't want to quibble over that, I guess. I think you make
9 a good point.

10 MS. SILVERMAN: I'm not sure it's a detail,
11 because what it is attached to is this question about
12 whether you should be focusing on some or one customer who's
13 vulnerable. And so I think it marries up into the line of
14 commerce questions.

15 PROFESSOR SHAPIRO: Okay. That's fair.

16 Well, one thing I think Hal said is that -- at
17 least an important part, if not the key, central part of
18 this analysis should be: What are the choices that the
19 buyers have, particularly with the bargaining negotiations?

20 What did you -- maybe even use the word outside
21 option. So that could be mentioned. And it's not really
22 mentioned here. Okay. I don't think that is a thing we
23 look for. What are the outside options, and how they would
24 be affected?

25 MS. SILVERMAN: So one of the things I think we

1 are talking about is it's not just a categorical listing of
2 suppliers. It's also tactics, bargaining options,
3 alternatives. It's what are the strategies and mechanisms
4 that buyers can use to withstand, overcome, resist. So it's
5 broader than just counting up suppliers and producers.

6 PROFESSOR SHAPIRO: Okay.

7 MS. SILVERMAN: It's --

8 PROFESSOR SHAPIRO: Counterstrategies. Would
9 they --

10 MS. SILVERMAN: It's all the competitive response
11 stuff, --

12 PROFESSOR SHAPIRO: Okay.

13 MS. SILVERMAN: -- in my mind. And I think that
14 is what is missing from this discussion.

15 PROFESSOR VARIAN: Yes. I would say that was the
16 sort of thing I had in mind when I said you should look at
17 this as a bargaining problem. If the good is typically sold
18 by one-on-one negotiations, and every one-on-one negotiation
19 is going to involve exactly those considerations, the
20 threats, the counterthreats, the alternatives, the options.
21 And those would be the relevant factors in looking at what
22 would happen when the competitive conditions changed.

23 PROFESSOR SHAPIRO: I think we, who are in this
24 project, are all aware we don't want to have a 150-page,
25 detailed thing that is going to describe all that in the

1 world. The cases are very different.

2 But, at the same time there are some principles
3 that seem relatively clear that can provide useful guidance,
4 such as how will the merger affect the relative bargaining
5 position or can the big buyers respond with counter-
6 strategies, and then how might that affect other buyers.

7 Then that gets to your question about, if there
8 are a few small buyers who are left with the vulnerability,
9 that leads to another question about what are the ultimate
10 market-wide impacts or impacts.

11 MR. WALDMAN: One thing you might want to think
12 about which is a little, slightly off point, is that I think
13 it's the IP Guidelines that actually have examples and
14 hypotheticals. I know this is giving you a ton more work,
15 but you may want to actually, under certain sections, give a
16 little bit of meat to the bones by giving hypotheticals and
17 answering them.

18 PROFESSOR SHAPIRO: Well, one of my questions for
19 public comment was whether we should do that. And I'm glad
20 that you have answered it.

21 (Laughter.)

22 PROFESSOR VARIAN: Let me follow up on what you
23 just said, because if there is price discrimination before
24 and then the merged firms merge and there is price
25 discrimination after, it may be that the small buyers are

1 not necessarily getting a worse deal. They are getting the
2 same sort of deal they were getting earlier. So it's the
3 change in the position of small buyers that is going to be
4 the most relevant issue.

5 PROFESSOR SHAPIRO: All right. Well, let me turn
6 to some questions from -- I see at least one important
7 person trying to ask a question. So let's do a few
8 questions from the audience before our lunch break. Okay.

9 COMMISSIONER ROSCH: Is this on?

10 PROFESSOR SHAPIRO: Yes.

11 COMMISSIONER ROSCH: That's the trick.

12 PROFESSOR SHAPIRO: Questions from the audience?

13 COMMISSIONER ROSCH: No. You just put the
14 question perfectly, because that is the trick. You have
15 identified a myriad of considerations that need to be taken
16 into account before you determine that the transaction is
17 going to have an adverse effect on competition from a price
18 discrimination standpoint.

19 The trick, however, is to distill those into words
20 of one syllable that are not going to be 20 of the sort that
21 Karen identified, for example, but are rather going to be
22 five of the sort that Hal talked about. That's what the
23 trick is. And I don't envy you that task, but that is
24 basically what we are going to be focusing on, because those
25 five have to be broad enough, from the standpoint of the

1 Commission, at least, that we can go in to court and we are
2 not going to be imprisoned; we are not going to be penalized
3 for not having the more fulsome list of things that Karen
4 talked about.

5 So the five have to be broad enough to embrace
6 those 20, and that is the trick. It's a tough thing to do,
7 but I think that is what you need to do.

8 PROFESSOR SHAPIRO: I will pass that along to the
9 Commissioners so that they appreciate the public input. We
10 are agreed. It's a balancing act. I think you used that
11 term, "balancing act," as well.

12 Other questions?

13 MR. HAYS: Hi. Thanks. John Hays.

14 Just in the context of large buyers, I wanted to
15 pick up on something Craig mentioned earlier, which is we
16 often hear in cases that merging parties will mention that
17 the customers have other things they are buying besides the
18 products at issue in the merger. And those are really the
19 source of leverage, the source of bargaining power. I
20 wondered if the panel could comment on what significance
21 should be given to that argument and in what circumstances
22 that might be persuasive and in what circumstances it might
23 not be.

24 MS. SILVERMAN: Just a couple things.

25 One is, like Craig, I think it's useful from a

1 practice perspective to start with, okay, well, can we
2 identify the group of customers who are most at risk or most
3 vulnerable and what do we have to say about them.

4 I think one of the other things I ask my clients
5 is what, in fact, keeps you up at night. And very often
6 it's what you are describing right now, which is these guys
7 have me so into them for the 48 other things that they buy
8 from me that there is no way I would -- and you ask it in a
9 very real world way, and you'll get those real world
10 answers, which is -- and that is why I start with: Well,
11 what actually constrains your pricing in this category. And
12 it may well be something sort of buried, if you will, and
13 sort of not front and center in the Guidelines-type
14 analysis, as that multiple-purchase scenario,
15 multiple-product scenario.

16 MR. WALDMAN: Yes. And I think the scenario that
17 you just posited, John, is the one that happens the most
18 often in large-buyer scenarios that I have dealt with which
19 is, you look the salesperson in the face and you explain
20 what the theory might be. And you say: I have been working
21 for three years to try to sell them all this other product.
22 Whether it's Wal-Mart and you want shelf space or something
23 else -- if you look at the economics of increasing this
24 price one percent, would I stand to gain on that by losing
25 these other sales in this other market or dramatically less,

1 and I'm not going to engage in that strategy.

2 There may be an economic reason to explain this.
3 So that is not a really, truly sound discipline strategy,
4 because you are not going to opt for another product in that
5 other market. But that is sort of a real world, and
6 economics may not be exactly overlapping in this scenario.

7 MR. ZONA: Buyers and sellers tend to commit to
8 one another, not always, but often if it's large buyers they
9 might locate close by or change the distribution system so
10 that they can accommodate that particular buyer.

11 All those things are investment -- they are sunk.
12 So they matter, but they are very difficult to include in a
13 HHI, even at the customer level.

14 PROFESSOR SHAPIRO: We are well past the HHIs in
15 this discussion, I think.

16 Others?

17 MR. FARRELL: Yes. So one follow-up on what you
18 were just talking about, it's all very well to talk about
19 sellers sleepless at 3:00 a.m. worrying about losing their
20 customer if they increase this price a little bit. But if
21 that were really such a big worry for them, they would be
22 inclined to reduce the price a little bit so as to reduce
23 the probability of losing the customer. And apparently they
24 have seen fit in the past not to do that.

25 So the fear of losing customers is already built

1 into the demand elasticity. And by hypothesis we have some
2 reason to think the merger will reduce the demand elasticity
3 of this particular customer. So why doesn't that already
4 take into account these concerns, as opposed to you have to
5 bring up these concerns as a second-round check after you
6 have thought about demand elasticity. That's something to
7 ponder late at night.

8 MR. WALDMAN: And herein lies the economic
9 difference from a business reality of when we talk to our
10 clients.

11 MR. FARRELL: Let me ask you a different question
12 that might seem easier or more interesting to respond to.
13 You've been talking about price discrimination.

14 We are, of course, very concerned -- I certainly
15 am -- with nonprice aspects of competition and possible
16 nonprice effects of mergers.

17 Is there a concern about nonprice discrimination,
18 quality discrimination, innovation discrimination, stuff
19 like that, or is discrimination really an issue that is most
20 likely to surface in the form of price?

21 MR. WALDMAN: I think it's far and away more
22 likely to appear in price just by the way bid markets work.
23 I think you are less likely to pull back on the quality or
24 innovation in a bid postmerger than you would just be
25 tweaking the price. That's my experience, at least.

1 But I guess logically it doesn't necessarily have
2 to be that way, but my experience in those defined markets
3 it's far and away more common that you are worrying about
4 price.

5 PROFESSOR VARIAN: Well, I would say one thing.

6 One thing we examined, actually in information
7 rules, we talk about one advantage of having a product line
8 and selling in differentiated markets is you can keep moving
9 the product up. So what was last year's luxury good now
10 becomes the mainstay of the market, and there is a new
11 luxury high-end product for somebody else.

12 So in some sense this idea of competing across an
13 entire product line gives you kind of natural force for
14 innovation, of moving a product quality forward.

15 PROFESSOR SHAPIRO: Maybe we'll take one more
16 question.

17 Gil, Gil.

18 MR. WALDMAN: Oh, here comes a better question.

19 MR. OHANA: This is something that has been
20 touched on a couple of times, and it's probably a better
21 question to ask Commissioner Rosch than anybody else. But
22 since he's not on the panel right now, I'll throw it to the
23 panel, which is:

24 What do you do in a deal where there is a small
25 set of customers you can reliably predict the deal's going

1 to be bad for, but it's neutral or maybe even positive for
2 others? How do you weigh those, and would the Guidelines
3 say anything about that?

4 PROFESSOR SHAPIRO: I'll take a quick -- not that
5 I should be answering questions, I suppose. I suggest
6 prosecutorial discretion, which can cover a multitude of
7 sins, no doubt.

8 MR. WALDMAN: Spoken kind of like a lawyer, Carl.
9 That was impressive.

10 PROFESSOR SHAPIRO: Thank you.

11 PROFESSOR VARIAN: That's an answer?

12 MR. WALDMAN: Yes.

13 (Laughter.)

14 MR. OHANA: -- one had like a ten-percent figure
15 for safe harbor?

16 PROFESSOR SHAPIRO: Tom, do you actually want to
17 say anything about it?

18 COMMISSIONER ROSCH: I think the point that Karen
19 made a little bit earlier is correct, though. And that is
20 the statute itself imposes a requirement of substantiality.
21 If and to the extent that you are talking about a
22 sufficiently narrow group of allegedly exploitable
23 customers, I'm not at all sure you satisfy that statutory
24 standard.

25 PROFESSOR SHAPIRO: The other things I'd say, Gil,

1 is we take seriously the consumer surplus, consumer welfare
2 standard in merger review. If you had harm to a few, a
3 small group, and benefits to a broader group, even maybe
4 smaller benefits but for a lot of them that would be
5 beneficial, then you need to show they are inextricably
6 linked to the other stuff. So there. That is the
7 moderator's answer to the question.

8 All right. Let me thank the panel. Let's break
9 for lunch.

10 (Luncheon recess taken from 12:47 p.m. to 2:04 p.m.)

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1 **PANEL 3: UNILATERAL EFFECTS**

2 **MODERATOR: JOSEPH FARRELL**

3 **PANELISTS: MICHAEL McFALLS, Partner, Jones Day**

4 **DANIEL L. RUBINFELD, Robert L. Bridges**

5 **Professor of Law and Professor of Economics,**

6 **University of California Berkeley**

7 **DANIEL M. WALL, Partner, Latham & Watkins LLP**

8 **M. LAURENCE POPOFSKY, Senior Counsel, Orrick,**

9 **Herrington & Sutcliffe, LLP**

10

11 MR. FARRELL: Good afternoon. Welcome to the
12 afternoon session. I think we'll get going, since it's the
13 appropriate few minutes past the advertised time, a little
14 bit of puffery without any actual deceptive practices.

15 This afternoon's first session is entitled
16 Unilateral Effects. Just to very quickly go through the
17 panelists, for identification, I won't give the
18 distinguished bios, on the far left, my far left, your far
19 right, we have:

20 Michael McFalls, who's a partner from Jones Day;

21 Next to Michael is Larry Popofsky who's from

22 Orrick, Herrington and Sutcliffe; then

23 Dan Rubinfeld who's the Robert Bridges Professor
24 at U.C. Berkeley and Senior Consultant Compass Lexicon; and
25 on my immediate left

1 Dan Wall from Latham and Watkins.

2 What I'm going to do is follow the practice, I
3 guess of at least one of the panels this morning, and just
4 talk for a couple of minutes myself, maybe a little more
5 than that, setting things up a little bit. And then I'm
6 going to ask each of the panelists if they have opening
7 remarks. And I'll ask them, I hope, provocative questions.

8 So the first thing I wanted to say is following up
9 on a promise that I made from the audience earlier this
10 morning, although the panel's entitled Unilateral Effects,
11 one of the questions that I had identified is really about
12 the relationship between unilateral and coordinated effects
13 and therefore, perhaps to some degree, about coordinated
14 effects.

15 If you look at the descriptions of unilateral
16 effects and coordinated effects in the 1992 Merger
17 Guidelines, the descriptions are very different. And they
18 make it sound as if these are two very different kinds of
19 animals. In the Unilateral Effects section, we'll talk more
20 about what unilateral effects are and how you diagnose them
21 and so on. The Coordinated Effects section is, I think it's
22 fair to say, very much inspired by thinking about firms
23 getting together, coming to some kind of explicit agreement,
24 not necessarily involving the use of illegal means of
25 coordination, but they all understand what it is that they

1 all expect each other to do; and, by golly, we're going to
2 discipline each other in a fairly deliberate kind of way so
3 as to make sure that we all stick to that agreement.

4 Well, I certainly would call that a coordinated
5 effect and the unilateral effects described elsewhere in the
6 Guidelines that also call that a unilateral effect. But it
7 does raise the question of whether there might be a gray
8 area, perhaps a rather large gray area, that's in between
9 those two modes of oligopoly conduct.

10 What I have in mind very particularly is the
11 following, which it seems to me is actually quite a common
12 mode of oligopoly conduct, and the question is where does it
13 fit, is it supposed to fit under unilateral, is it supposed
14 to fit under coordinated? And, if so, does the description
15 of one or the other of these forms of conduct need to be
16 changed in order to better reflect and communicate that we
17 have in mind to include this form of conduct.

18 So what's this form of conduct that I'm concerned
19 about? It's where there's no agreement and established set
20 of punishments for deviation from the agreement, but neither
21 do the firms act completely independently. I recognize that
22 if I change my price or introduce a new, improved product,
23 my identifiable rivals are probably going to respond and
24 react not so as to punish me but because their competitive
25 environment is somewhat changed and so they're going to

1 respond to that.

2 If I take into account that my competitive
3 initiatives are going to be responded to, typically in a way
4 that means that when I cut my price, others will cut their
5 price; when I innovate, others will scramble to innovate,
6 that's going to blunt the incentive for me to do any of
7 those things, because it basically means that instead of my
8 taking as given the deals offered by the other firms and
9 seeing where I can profitably offer consumers a better deal,
10 I'm thinking about what happens when we all offer consumers
11 a better deal and is that good for me.

12 So that form of oligopoly conduct, to the extent
13 that that's being observed in the real world, which I think
14 is a large extent, is that supposed to fit in the Unilateral
15 Effects section, so unilateral effects are not just about
16 static, simple modes of competition with full independence
17 or is it supposed to fit in the Coordinated Effects so
18 coordinated effects are not just about common understanding
19 with detection and punishment. Or is it inevitable that
20 there's a gray area in between and, if so, what should we do
21 about it?

22 So I'll have some other questions to hit the
23 panelists that are perhaps more narrowly on Unilateral
24 Effects, but since the relationship between unilateral and
25 coordinated effects came up earlier, I thought I'd try to

1 frame the unilateral effects discussion by saying: As
2 compared to what.

3 Okay. So with that set-up, let me ask the
4 panelists to deliver any opening remarks they have in the
5 order in which I introduce them, so we'll start with Mike
6 McFalls.

7 MR. McFALLS: Thanks. And I'm going to sit down
8 here as long as the other panelists and the audience don't
9 mind. My knee hurts. Joe said that we'd have five to ten
10 minutes of opening remarks, and I promise not to go longer
11 than that and probably will be considerably shorter.

12 I come at this from the perspective of somebody
13 who doesn't go to a courtroom. I do most of my work in
14 front of the Agencies and often outside of the Agencies,
15 before we even get there. I have seen the application of
16 unilateral effects models in industries, ranging from
17 satellite radio to shampoo to cigarettes, to just about
18 every product under the sun. Of course when I was at the
19 FTC in the late '90s, I saw the application of the theories
20 then.

21 To me maybe it's a result of time and experience,
22 but these are pretty understandable, comprehensive,
23 applicable models. There's been innovation and practice
24 reflecting economic learning over time. And now it's
25 bubbling to the surface in the form of the UPP that we've

1 already discussed today and earlier forms of that, like the
2 PPI by Salop and O'Brien.

3 All these things are good things. The defense
4 lawyers often make use of these even before the Agencies do.
5 With the UPP, in particular, I know that before I ever heard
6 anything from the Agencies, we had one of our consultants
7 come to us and recommend that we try to do something with
8 this and use it affirmatively. I think that's largely true
9 of a lot of differentiated products theories: They're used
10 originally to defend mergers, showing that you're not really
11 close together in product space.

12 So, generally, you look at the Guidelines and you
13 look at this section of the Guidelines, and I look at a lot
14 of the comments and I'm sort of puzzled by people really
15 want to change. Of course it's my inclination as a defense
16 lawyer to want stability. The greatest boxing trainer in
17 the world right now was being interviewed. He trains Manny
18 Pacquiao. He goes: When I watch film of an opposing boxer,
19 I don't look for weaknesses, I look for patterns. I think
20 that a lot of defense lawyers do, so a lot of defense
21 lawyers are going to be uncomfortable with significant
22 changes in the Guidelines.

23 But if the significant changes are nothing more
24 than the things that we've been looking at for a couple of
25 years now, not only should we be comfortable with it, just

1 as a matter of principle they should probably be reflected
2 in Guidelines. And even though things like the UPP are not
3 widely practiced now, if they're going to be used by the
4 Agencies in their particular circumstances, and it's going
5 to continue to be that way, then why not put them into the
6 Guidelines with the proper caveats?

7 Obviously I don't need to advise the Agencies on
8 the dangers they face in doing this, but once you put it in
9 the Guidelines it suggests that if you're in those factual
10 circumstances and you don't have the data, then you don't
11 have a presumption, period. So the Agencies need to be
12 careful and should be careful anyway to make clear what's
13 pretty obvious, which is this is just a tool, like
14 everything else that we do in merger analysis, and is going
15 to be used in conjunction with all the other evidence that's
16 going to continue to be collected during the second request
17 process. We know that's not going to change any time soon.
18 If it doesn't, then why not make use of the documents?

19 The documents really tell the story. It depends
20 on viewing all of them in their proper context, but you have
21 to use the documents in conjunction with economics to come
22 to an appropriate understanding of whether or not
23 transactions are going to result in unilateral effects.

24 So if the UPP works, should it be the exclusive
25 touchstone for liability in a unilateral effects case

1 involving differentiated markets? I don't think the authors
2 originally imagined that it would be more than a screen at
3 this point. And certainly there are reasons that you
4 probably don't want it to be the exclusive touchstone that
5 I've already talked about. When you look at diversion
6 ratios you're going to have to come to a consensus about
7 what the proper proxies for those are. You're rarely going
8 to have direct evidence of diversion ratios.

9 My experience with agency staff thus far is that
10 there is a very wide division of opinion among agency staff
11 and of course with defense counsel over what those proxies
12 should be in a given case, and that's after a lot of
13 investigation and discovery.

14 Can you use turn in telecommunications industries
15 as an indirect proxy for diversion? Can you use
16 longitudinal usage data in prescription drugs? Everybody
17 knows that those don't necessarily reflect changes due to
18 price changes, but do they reflect nothing?

19 Are you going to simply say that if it's not
20 perfect evidence we're not going to use it all? And if
21 that's the case, then you really have to think about what
22 kind of Unilateral Effects Guidelines you're going to want
23 to have. When you look at the ones we have today, they work
24 fairly effectively.

25 That said, a couple of points. Nobody really

1 thinks that the 35-percent threshold is workable. I use it
2 internally, just as a guidepost to think if we're not over
3 35 percent in a reasonably-foreseeable market it's less
4 likely that we're going to have a unilateral effects
5 problem. You can't reasonably counsel that it's impossible
6 that you're going to have one.

7 Should it be used as a baseline for presumption of
8 potential anticompetitive effects? You know, if you want to
9 keep it, keep it, but realize that people are going to
10 continue to think of it as a safe harbor if you fall below
11 it.

12 Of course the biggest safe harbor is a more subtle
13 one, which is are the Agencies going to continue to focus on
14 whether or not you're the first and second choices for a
15 significant number of customers. Well, if you look not just
16 at the UPP but at more complex economic simulation models
17 that take in a lot more data and variables, the answer is
18 no. You can have unilateral effects if you're the first and
19 third choices or first and fourth or second and fifth
20 choices. It depends on the assumptions that you have and
21 the data that you have.

22 And if the Agencies and the Bar are honest about
23 that, then I don't think you can limit a unilateral effects
24 case to firms who use products of the first and second
25 choices for a significant number of customers. But, that

1 said, if you're going to use first and second choice as the
2 touchstone, then I think that one mistake that I continue to
3 see from the staff is thinking that if a high number of
4 users of Product A would go to Product B in the event of a
5 price increase, that means that they're first and second
6 choices for a significant number of customers. And that's
7 not true. That's a significant number of customers of the
8 merging products. But significance in the Guidelines, and
9 maybe this is just a misreading and maybe suggests an
10 ambiguity that needs to be corrected, significance must
11 refer to the relevant market. I mean it can't be referred
12 to the merging products themselves.

13 So, with that thought, I'll conclude my remarks.

14 MR. FARRELL: Thank you.

15 Harry.

16 MR. POPOFSKY: Well, thank you. I'm very pleased
17 to be here with such distinguished colleagues, at least
18 panelists, they're not exactly colleagues.

19 I was at a loss to know exactly what I might
20 address today. I thought I'd get some inspiration from
21 George Clooney, "Up in the Air," but it was about another
22 subject, so I turned to a source who I know some of you know
23 which is a better source, my son Mark at Ropes Gray.

24 And I said: Son, what do you think I might
25 address?

1 And he said: Don't worry. With that panel you
2 won't have to say anything.

3 (Laughter.)

4 MR. POPOFSKY: But I have an opening allotment.
5 And with an opening allotment, I figure I'll take my shot,
6 nonetheless.

7 I start with the conviction that we are dealing
8 here with an administrative regime, intending to implement a
9 rule of law, principally Section 7. This is not simply an
10 exercise in applied economics, but it requires some
11 adherence and some respect for established precedence, it
12 seems to me, as established in the courts. And I predict
13 the courts will not depart from analyzing a range of factors
14 in defining the market and what effects are substantially,
15 and I will underscore the word in the statute as
16 Commissioner Rosch did in his comment earlier, what
17 substantially may lessen competition or create a monopoly.

18 I have no doubt that economic models may be useful
19 in addressing that issue, but they invite a duel with
20 alternative models based on different methodology and
21 different data assumptions. And for that reason almost
22 alone courts are not, in my view, going to accept arithmetic
23 algorithms, if that's what they are, in lieu of market
24 definitions and market share indices in trying to assess
25 whether there is a risk of untoward market power by reason

1 of a merger transaction.

2 I believe there is a significant risk of
3 disconnect between the administrative approach to the rule
4 of law and then in the courts. That disconnect imposes a
5 degree of uncertainty and unwanted cost on the economy. And
6 I have in mind my brother Dan's case, *Oracle*, which may be
7 an example of that. *Whole Foods* may be an example of that.
8 But it does seem to me that the administrative process has
9 to be geared to what should be anticipated in a court of
10 law.

11 I certainly accept the desirability of
12 administrative safe harbors, such as those seemingly
13 intended by the original HHI Guidelines, but the search for
14 the holy grail, combining simplicity with accurate
15 predictability, has the potential to miss price constraints
16 imposed by real-world conditions and competitive responses
17 by other actors in the market. And that of course is the
18 question which was posed by Mr. Farrell at the outset: Can
19 you really compartmentalize and what about the gray area in
20 between.

21 However comfortable one is with the assumptions of
22 the model used to isolate potential unilateral effects, in
23 my view, having read far too many articles on the subject in
24 the last week, it is inherently at risk in terms of getting
25 it right, given its dependence on diversion ratios,

1 standard-efficiency offsets, assumed pass-through rates,
2 buyer-demand curves, any and all or all combination of them.

3 The risk of error one way or the other on each
4 variable is concerning and potentially costly, in my
5 avocation. I'm more or less a historian, not a
6 mathematician. I remember Long Term Capital Management,
7 where our economy was almost brought to its knees by the use
8 of mathematical models based on a data stream which the
9 Nobel laureates after the fact said was too narrow
10 historically. Niels Bohr I think it was said, quipping,
11 that it is a very difficult thing to predict, particularly
12 about the future.

13 Beyond obvious cases, which are likely to be
14 caught by refined and improved market power screens, perhaps
15 updated HHIs which reflect what actually goes on rather than
16 what appears in the current Guidelines and perhaps even, and
17 I am fond of it, the old 35-percent standard. Justice
18 O'Connor didn't shy it away from it in Tylenol when she used
19 30 percent. Any screen can only be a starting point for
20 analysis and should not, in my view, be elevated into a
21 presumption.

22 I'm skeptical about any proposal to rewrite the
23 Guidelines to give economic models pride of place when a
24 wealth of other market information is available and
25 necessary to assess a merger in the round, as it were. The

1 temptation in the administrative process to short change
2 nonmathematical evidence, that is to say, deprecate such
3 things as competitive response, buyer response, entry, and a
4 myriad of other concerns, suggests that the overriding
5 principle in any rewrite of the Guidelines is that which is
6 captured by Mies van der Rohe's maxim, "less is more."

7 With that, I'll pass the baton.

8 MR. FARRELL: Thank you.

9 Dan.

10 PROFESSOR RUBINFELD: Thanks. As the only
11 economist on the panel I feel like I should make a speech
12 for economic models, but I'll forego that for the moment.

13 Many of the comments I'm about to make reflect a
14 joint submission I've done with Richard Gilbert and I should
15 just exempt Rich from the comments I'm going to make towards
16 the end of my five minutes.

17 The first point I wanted to make was that in
18 looking at Unilateral Effects, I share Larry's concern about
19 screens. In particular, I think I agree with Mike about the
20 35-percent screen for Unilateral Effects. I don't think
21 there's any economic foundation for that screen, and it's
22 very easy to imagine mergers which would have substantial
23 unilateral effects which would nevertheless fall by way if
24 that screen were taken to be a serious one, so I'm hoping
25 that that screen will disappear in the revision of the

1 Guidelines.

2 The main point I wanted to talk about was market
3 definition and how it relates to unilateral effects. Market
4 definition works fairly well in very traditional,
5 homogenous-goods markets, but it's probably most important
6 in markets with differentiated products. And there I think
7 we need to realize and account for the fact that there's a
8 very close link between market definition and analysis of
9 competitive effects.

10 The way I like to think about it is just to
11 imagine you're looking at a merger between two firms, A and
12 B, and typically if you're going to do a market-definition
13 analysis, whether you're using critical loss or some other
14 -- or more traditional, classic guidelines, a SSNIP test,
15 you're going to be basic focusing on how close A and B are
16 to each other. Basically if you're in a Bertrand world,
17 assuming very little if any competitive response from any of
18 the firms in the market, so this would sort of rule out the
19 case Joe was raising before, you will go through the usual
20 series of steps to analyze a market. If you're doing a
21 competitive-effects analysis, you're really just adding
22 something to that. You're adding an analysis, a more
23 serious analysis of the competitive, strategic response of
24 other firms in the market. You're considering repositioning
25 and entry, and so on.

1 Now in many mergers of course those additional
2 analyses are going to be very significant, but then there
3 are going to be some cases where the two are going to be
4 very similar. And my concern is that sometimes the effort
5 to literally follow the Guidelines or market definition will
6 end up distracting you from focusing on the important points
7 about competitive effects.

8 I personally have seen a number of cases, both
9 when I was with the Justice Department and since I've left,
10 where the merger might be a merger where there are four
11 firms in the market and A is acquiring D, and so the
12 market's going to have A, B, and C instead of A, B, C, and
13 D, and you want to know whether the removal of that one firm
14 in the market will necessarily have a competitive effect.
15 It may be very hard to define a relevant market in that case
16 because it may be that the exercise of going through the
17 SSNIP test just is not one that has a clear answer. You
18 just don't have enough track record historically or the
19 market is very dynamic. But it may be very clear that the
20 removal of D as a competitor would have a significant
21 competitive effect because of D's particular nature, because
22 it's been a maverick like firm, or whatever.

23 My view would be in those cases where you don't
24 have solid evidence of exactly where to draw the line on the
25 market, but you have very clear, strong evidence of

1 competitive effects, that the Guidelines ought to reflect
2 the fact that it's okay in selected cases to do the
3 competitive-effects analysis and, to keep my lawyer
4 colleagues on the panel happy, you can back out the market
5 definition that's consistent with your competitive-effects
6 analysis. You would just, in a sense, reverse the order in
7 which you think about the process.

8 Once you're done, the market you define will be
9 entirely consistent with competitive effects, and I've seen
10 that happen in many cases. I don't see any problem with it
11 if it's done carefully. I think it would avoid, I wouldn't
12 say the embarrassment, but the difficulty of having a battle
13 about a market definition whose answer really doesn't matter
14 for purposes of the analysis of competitive effects.

15 Now the second point I wanted to make quickly is
16 that I'm hoping the Guidelines, when revised, will reflect
17 the fact that we're in a more complex world and there are
18 certain dimensions of that complexity which make market
19 definition difficult. We have a lot to learn from
20 economics. I don't think the Guidelines can spell out the
21 right formulas, I don't think we know enough, but it could
22 certainly reflect the importance of that complexity.

23 What I have in mind specifically are cases that
24 arise usually where two or more products are complementary.
25 When they're complementary, the analysis of competitive

1 effects may differ depending on whether the complements are
2 always sold as a bundle or whether they can be or are
3 sometimes sold separately in a marketplace. That
4 distinction would be very important.

5 An example of that might be some of the after-
6 markets cases which we've seen where there's obviously a
7 significant issue as to whether the product being
8 manufactured is complementary to some of the after-market
9 services, should you look at that as a single product or
10 should you focus on separate markets.

11 Another example which is becoming more important
12 are two-sided markets, where you have examples of two
13 different kinds of firms whose services are fundamental to
14 the functioning of the market. If you were to take a look
15 at market definition, looking at only one side of the
16 market, you would almost certainly get the wrong market
17 definition, you'd probably get a view of the demand
18 elasticity that's lower than it really ought to be once you
19 reflect the fact that there is a two-sided response.

20 I don't have a specific suggestion about exactly
21 how to do that analysis. I think we're still moving up the
22 learning curve, but I think the Guidelines should reflect
23 that important complication.

24 Also related but moving it to the innovation area,
25 there are lots of instances where R & D and its effect on

1 innovation can be analyzed in a merger by accounting for the
2 fact that the R & D of the two firms may or may not be
3 complementary. I think if they're complementary, there may
4 be certain benefits associated with the acquisition, but if
5 they tend not to be complementary, there may be certain
6 duplication. Either way the analysis of the merger should
7 reflect the nature of a complementarity of the R & D of the
8 merging firms.

9 Now let me just take one more minute to try to get
10 back to Joe's question about unilateral and competitive
11 effects. It strikes me just as an aside that it wouldn't be
12 a bad idea, which I assume you're doing already, to follow
13 the debate over the merger guidelines in the EU, which is
14 still continuing as far as I can tell, and the EU has taken
15 a slightly different position on these issues. I think it
16 actually goes to Joe's question. Because, at least as I
17 read it, the EU guidelines, as I last read them, don't
18 describe the term unilateral effects, they called them
19 "noncoordinated effects." They say unilateral effects can
20 arise when a merger creates or strengthens the dominant
21 position of a single firm. Whereas the U.S. Guidelines tend
22 to talk about lessening of competition as it arises for
23 unilateral effects.

24 Now I may be wrong, as I read that, if we were to
25 take, say, a simple model where we have some kind of

1 Stackelberg leader responding strategically to the
2 possibility that the other firms in the market will respond
3 to its behavior and the other firms responding accordingly,
4 the EU would say that's a noncoordinated effect. Whereas in
5 the US, I think the sort of Stackelberg kind of case we
6 would almost think of as outside and we'd probably put it in
7 a coordinated area.

8 So I'm not a big fan of necessarily coordinating
9 that, following exactly what the EU does, unless they happen
10 to be right. But it might be useful to try to think about
11 whether some convergence on the language here is beneficial.

12 Thanks.

13 MR. FARRELL: Thank you, Dan

14 Dan Wall.

15 MR. WALL: Thank you and good afternoon. And I
16 also appreciate this opportunity to participate in the
17 workshop. I appreciate somewhat less having to follow these
18 three with my opening statement, but many of the great ideas
19 I had are now gone and made.

20 The subject of this panel, Unilateral Effects, is
21 certainly one that's near to my heart because practicing
22 here in and around Silicon Valley, virtually every merger
23 that we see ends up being one that is assessed by a
24 unilateral effects paradigm rather than a concerted action
25 or coordinated effects paradigm. It's a doctrine that's far

1 more important to the companies in the Valley than
2 coordinated effects analysis is ever going to be.

3 Of course as was mentioned, I also litigated along
4 with a few people that are in the room here, one of the
5 principal cases, which is the DOJ's challenge to the Oracle-
6 PeopleSoft deal.

7 I want to make four points in my opening. The
8 first is that I definitely fully support the process of
9 making revisions to the Merger Guidelines generally and to
10 the Unilateral Effects section specifically.

11 It's interesting, the 12 years that have passed
12 since the Merger Guidelines were last revised, happens in
13 the case of unilateral effects to encompass a very large
14 percentage of the time that the doctrine has existed. It is
15 certainly a period of time in which a lot has happened, as
16 Mike was referring to earlier, and I do think that there is
17 uncertainty out in the world about how much of that has made
18 its way into the mainstream enforcement practice, how much
19 is relevant largely just in the economic literature as
20 background. Addressing that, I think would be great.

21 An example I will give is that the unilateral
22 effects analysis most pertinent to the *Oracle* case is
23 referenced at best in footnote 21 of the Guideline in a
24 brief paragraph in Section 2.212 regarding markets where
25 it's costly for buyers to evaluate product quality. The

1 entirety of that can't be more than 60, 70, 80 words. And
2 it is not terribly illuminating about how to conduct that
3 particular kind of analysis, which deals largely with
4 markets in which there are auction like conditions.

5 I can also say that on more than one occasion I've
6 tried to make arguments to the Agencies based on concepts
7 from the Unilateral Effects section of the Guidelines, only
8 to be told that I was wrongly referencing the standard-
9 differentiated products case, not some more nuanced version
10 of unilateral effects analysis that was appropriate for that
11 case. I think it would be fair if we had a somewhat more
12 comprehensive treatment. I realize that there will be
13 diminishing returns at some point to that because we get a
14 lot of very unusual situations, but it would be good for all
15 if the revised Guidelines were more comprehensive in the
16 kinds of unilateral effects scenarios that the Agencies are
17 concerned with.

18 Second, and harkening back to something that was
19 said earlier, I think that revised guidelines need to
20 decouple the discussion of unilateral effects from the
21 coordinated effects discussion more than they do now.

22 To me the Unilateral Effects standards in the
23 Guidelines are a kind of antitrust centaur in which you have
24 the head of a unilateral effects analysis that has been
25 grafted onto the body of a coordinated effects analysis.

1 And what I mean by that is that the foundational market
2 concentration discussion in Section 1 of the Guidelines
3 seems to have been written on the foundation of *Philadelphia*
4 *National Bank* and its antecedents and how coordination is
5 more likely in concentrated industries.

6 The discussion of coordinated effects seems to
7 follow fairly natural from that foundation, but when you get
8 to Section 2.12, the Unilateral Effects section, I would
9 argue that it does not. It's somewhat of an awkward fit
10 with a poorly-articulated and, I would say, poorly-reasoned
11 statement that where market concentration data fall outside
12 the safe harbor regions of Section 1.5 and the merging firms
13 have a combined share of 35 percentage, a presumption of a
14 unilateral effect or, more specifically, that a substantial
15 number of customers view the merging parties as their top
16 choices is appropriate.

17 As has been mentioned, it's not clear why that
18 exists. It's not clear where the numbers came from. It's
19 not clear why one would graft the unilateral effects head
20 onto that body, and I think it would be better for all that
21 the Agencies sort of rework that.

22 I fully appreciate that there are positives and
23 negatives of going down that path. I would say the big
24 negative is that it would confirm, at least to me, something
25 which I have maintained for some time, which is that the

1 *Philadelphia National Bank* presumption ought not apply to
2 unilateral effects cases.

3 As an historical matter, it rests on economic work
4 that was cited by the court and argued in the parties'
5 briefs in that case, about the propensity of concentrated
6 industries towards collusion. It was also developed at a
7 time when, to be fair, the only unilateral effects case that
8 anyone had ever heard about was the occasional merger to
9 monopoly. It is woefully incomplete as a basis for
10 inferring a unilateral effect. And, in candor, I think its
11 only utility in these cases is that the Government likes to
12 cite it in litigation for the tactical advantages that that
13 creates.

14 I don't think that that value is sufficient to
15 allow it to confuse unilateral effects analysis. I would
16 prefer the Agencies to say that in differentiated products
17 cases or some other natural fork in the road where you would
18 tend to go in the direction of unilateral effects case, you
19 look at market structure, which certainly you would need to
20 do in one way, and articulate what those standards may be.

21 The third point I want to make echoes what Larry
22 said and that is that I think that any revised Unilateral
23 Effects Guidelines needs to be written with due respect for
24 the limits of Section 7 of the Clayton Act and with an
25 appreciation that unilateral effects models that are present

1 in the literature can condemn mergers that may not have the
2 proscribed effect for one substantially lessening
3 competition in a line of commerce.

4 My major concern with unilateral effects analysis
5 generally has always been that it can be used to condemn
6 mergers based upon their effects on groups of customers
7 within a market, even though the market is not affected
8 generally.

9 *Oracle* is a perfect case in point. In that case,
10 one of the Government's experts testified based upon auction
11 theory that about 20 percent of the customers in the
12 relevant market, constituting those who viewed Oracle and
13 PeopleSoft as their best substitutes, would experience a
14 postmerger price increase, the other 80 percent would not.
15 They would not suffer a price increase because someone other
16 than the merging parties was one of their two best options.
17 And under the same auction theory, that prevents the adverse
18 effect from occurring.

19 Well, without arguing whether that's true or not,
20 I would question whether on its face an adverse effect of 20
21 percent of the customers in a relevant market satisfies the
22 Section 7 requirement of substantially lessening competition
23 in a line of commerce. We briefed in that case not
24 specifically to this example but in general that it would
25 not. Just because I can't resist, I would note that at the

1 top of every one of those briefs is the name Tom Rosch.

2 (Laughter.)

3 MR. WALL: Now there isn't a great deal of law on
4 this, but what there is suggests that substantiality is in
5 relation to the market as a whole and that the market must
6 be generally affected or at least a sizable portion of the
7 market approaching or exceeding a majority. Obviously not
8 everyone needs to be at risk, but I question whether effects
9 in discrete corners of the market really suffice under the
10 law.

11 I've seen economic papers postulating that
12 significant unilateral effects could be established because
13 firms with quite small market shares, sort of Vons Grocery
14 kind of market shares, are particularly close substitutes.
15 I won't claim that I'm qualified to critique the economics,
16 but I will claim some comparative advantage in interpreting
17 the statute. I will say that I just don't believe that a
18 merger that was prosecuted solely under that theory and was
19 prohibited would withstand appeal and certainly not if in my
20 lifetime the Supreme Court takes a merger case again. Of
21 course that's unlikely.

22 The statute does not proscribe mergers, the effect
23 of which may be to create upward price pressure in pockets
24 of a relevant market. New Guidelines, I submit, need to
25 respect that.

1 Fourth, and finally, I strongly urge you to
2 approach the new Guidelines with an appropriate sense of the
3 limits of economic models to predict future price increase.
4 Unilateral effects analysis has been a particularly fertile
5 area for innovations in antitrust economics and particularly
6 for those who assert modeling and simulations can be used as
7 primary means of meeting the Government's burden of proof.

8 To my knowledge, however, there is very little in
9 the way of empirical proof that ex ante predictions of
10 increased prices pursuant to these models have been
11 validated ex post. I can certainly say that the predictions
12 of the Government's auction theorist in the *Oracle* case who
13 said that at least 20 percent of the customers would
14 experience nearly 100-percent increases in prices as a
15 result of the merger, which of course was consummated, they
16 were completely wrong. Prices have not increased to any
17 meaningful degree, let alone to that predicted amount. So I
18 worry a lot that new Guidelines will over emphasize these
19 intriguing but fundamentally unproven tools.

20 Sometimes the qualitative analysis simply works
21 better. Personally I think the most important part of
22 unilateral effects analysis is focusing on repositioning, a
23 subject that gets no more than a couple of sentences in the
24 existing Guidelines.

25 Evidence of historical tendencies to respect

1 competition from the merger partner more than from others is
2 also very important in making out the case.

3 I appreciate the desire to develop and implement
4 these new econometric methods of proof, but respectfully I
5 would question whether those methods are ready to take a
6 prominent role in new Guidelines.

7 So thank you very much and I look forward to
8 answering questions.

9 MR. FARRELL: Thank you.

10 So let me come back to the question that I started
11 out with about the gray area or dividing line, whichever it
12 is, between unilateral effects and coordinated effects. I
13 think I heard Dan Rubinfeld say that at least according to
14 the EC guidelines you think Stackelberg oligopoly would be
15 viewed as an unilateral effects model.

16 And Dan Wall, I think you expressed some view on
17 where the dividing line might be, but I wasn't quick enough
18 to write it down. Can you refresh us on that?

19 MR. WALL: Well, this is an interesting case in
20 point about the interrelationship between statute and
21 analysis and Guidelines and how they articulate things. I
22 think that the EU has that verbiage difference having the
23 noncoordinated and coordinated because of the statutory
24 basis for prohibiting mergers in Europe, which as an
25 alternative to a coordination theory needs to have some

1 dominance element. They just need to check the dominance
2 box. So they tend to approach it that way.

3 Coordinated effects to me is generally thought of
4 as a straightforward, tacit-collusion kind of theory.

5 MR. FARRELL: So the gray area that I talked
6 about, you would regard assuming it to exist as unilateral?

7 MR. WALL: I would put it in unilateral because,
8 as we say, the taxonomy that we have, it gives me the only
9 other choice as unilateral, yes.

10 MR. McFALLS: I'm not sure I understand what the
11 practical import would be in the Guidelines or in practice,
12 because take the example of RJR/Brown & Williamson. The
13 Commission investigated under both unilateral and
14 coordination hypotheses. If the theory is, well, you're not
15 going to have coordination the way you might have with milk
16 and cement in differentiated product markets, that's true.
17 You can investigate that as a coordination hypothesis
18 anyway.

19 If it's, well, the parties we've shown are going
20 to have a unilateral price increase and now we're just
21 quantifying how much other companies are going to raise
22 prices, I mean I think you've already got the violation
23 through a unilateral price increase, so I'm just trying to
24 understand.

25 One aside about the UPP and similar measures.

1 Part of the problem I think that a lot of lawyers may have
2 with it is the sense that when you look at gross margins,
3 and they assume such a significant portion of the analytics,
4 certain inferences arise about the competitiveness of
5 businesses with large gross margins that are not consistent
6 with a lot of people's, at least, intuitive experiences with
7 businesses.

8 So if you look at shampoo, for instance, Proctor
9 and Gamble has a significant gross margin in the shampoo
10 market, but how many of us can really say that Proctor and
11 Gamble isn't really using advertising, which is generally
12 categorized as a fixed cost, to compete effectively. It's
13 essentially the flipside of price to Proctor and Gamble, so
14 it's a variable of competition.

15 There are a lot of businesses with gross margin --
16 I'm putting aside all of the software businesses out here
17 that are competitive -- and that it doesn't really tell us a
18 lot about the competitiveness of those businesses. So
19 that's just a general aside.

20 MR. FARRELL: I'm mostly here to ask questions,
21 but I will answer that one. I mean the issue in a merger is
22 not is the industry competitive and it's not does this firm
23 face competition. It's what's the impact of the change --

24 MR. McFALLS: Sure.

25 MR. FARRELL: -- here to this merger and in

1 certain circumstances it turns out that the answer to that
2 is going to be related to gross margins. It doesn't have to
3 be filtered through some perception that high-gross margins
4 are an indicator that there's no competition out there,
5 although people sometimes talk in that way.

6 MR. WALL: But it's not just what happens in the
7 abstract. It's whether competition is lessened
8 substantially. That's the only statutory language we have
9 to go off of. And if an effect, upper price pressure, what-
10 have-you, that cannot directly be traced to the loss of
11 rivalry, the loss of intensity of competition, what-have-
12 you, shouldn't count as a legal matter under the statute.

13 MR. FARRELL: Well, I think there must be legal
14 questions that many lawyers could spend a lot of time on
15 there if you're going to raise the possibility that an
16 effect that is due to the cessation of rivalry between two
17 horizontal competitors might not be due to the loss of
18 competition. But I'm probably not the right person to pose
19 the pointed questions here.

20 Dan.

21 PROFESSOR RUBINFELD: Well, I was just going to
22 say maybe I'm wearing my law professor's hat now, but for me
23 it's nice to know the narrow definition of coordinated
24 effects. We have pretty strong case law and there's a
25 certain avenue that the Agencies can go through and have

1 with some success. If we start defining that space to
2 broadly include what I think is more something that's more
3 like unilateral effects, which is more elusive, I think
4 we're actually losing some of the sharpness we have from
5 pursuing these sort of traditional coordination cases.

6 I was just going to mention in passing, Mike
7 mentioned RJR/Brown & Williamson, I happened to be the
8 outside expert for the FTC in that matter, and I can't
9 reveal everything I did. But I'd just say I don't think I
10 have any trouble distinguishing between what I thought of as
11 a traditional coordinated view of that market and unilateral
12 effects view, and I thought I looked at both when I was
13 developing my opinion on the case.

14 So I know the line between unilateral and
15 coordinated is fuzzy, but I would be uncomfortable actually
16 if you were to broaden that very far because I think you
17 would hurt some of the clear presumptions we have, in those
18 few cases that Dan Wall sees that are coordinated.

19 MR. McFALLS: I'm sure they exist.

20 MR. FARRELL: Larry.

21 MR. McFALLS: One other impact that arises, and
22 RJR is an example and Miller/Coors is another, Heinz Baby
23 Foods is quite another. When you apply a lot of the models
24 and UPP, and we found this in another pharmaceutical case,
25 what you end up having as a possibility is a presumption

1 against mergers, of course as Dan said, small market-share
2 firms that would like to compete more significantly against
3 larger firms.

4 A lot of the larger firms are must-have products.
5 So you're not going to get a lot of diversion to them. So
6 ironically you have these cases where it's really the second
7 and third firm combinations that raised the most issues. It
8 makes sense intuitively because that is the most competition
9 that could be lost in the market because that's where the
10 locus of competition is. Understand that longer-term
11 competitive dynamics, and I think the Commission saw that on
12 RJR, baby food, and maybe Miller/Coors, it's really good to
13 have a strong number two on these plays. And you may not
14 have as much flexibility as a prosecutor doing that if you
15 apply the models in a mechanical fashion. Nobody's
16 proposing that you do, but I think that could be lost.

17 MR. FARRELL: Yes. I mean nobody is proposing
18 applying these models in a purely mechanical fashion or
19 making them the sole touchstone. I mean that's --

20 MR. McFALLS: With that said, the UPP I have seen
21 applied at the end of an investigation, not at the
22 beginning. After you've gone through the trouble of
23 producing documents, for months, having it come back to you
24 as a presumption at the end of an investigation is a little
25 unsettling. I mean it's something that can be managed

1 ultimately. If parties disagree with it, they always have
2 the theoretical option of litigating.

3 MR. FARRELL: Let me use that as a segue into my
4 second question for the panel, which is: In the end a
5 litigated case inevitably is going to be about everything.
6 Pretty much everything is going to be worth bringing up for
7 one side or the other, and in many cases both.

8 And it's got to be a story and it's got to involve
9 every motive analysis pretty much that you can think of.
10 But in terms of dealing with the thousands of mergers a
11 year, almost all of which are never litigated, what's the
12 right way to diagnose relatively quickly which ones to pay
13 more attention to, to worry about more, to go the next step
14 or the next step after that.

15 So I have a little list here which I think I
16 emailed to you gentlemen of four things that have been
17 proposed as handy diagnostics, the Herfindahl, the change in
18 the Herfindahl, some sort of measure of upward pricing
19 pressure, and the number of firms.

20 And I will say that my own staff in describing
21 mergers to me, when they tell me what's happening with some
22 new merger that's coming across the transom, they very often
23 use the N measure. They say it's a four-to-three.

24 And I say, oh, is that the right diagnostic?

25 And they get a little sheepish. But it is

1 actually used widely in practice inside the Agencies.

2 So do you have thoughts about if one's going to
3 use, and I think it's inevitable that we have to use, given
4 the number of mergers we deal with, even in a merger trough,
5 if you're going to use some relatively simple measure that
6 says, yes, every horizontal measure in some sense eliminates
7 some rivalry, but some of them a lot and some of them a
8 little, and how do you measure that?

9 How should one use some combination of these four
10 or other things?

11 And, follow-up question, when you've done that,
12 since it's not the end of the story, by any means, what's
13 the best thing to do next, what's the immediate comeback
14 that might save a lot of trouble if you look at it quickly
15 rather than plunging into some big next step?

16 PROFESSOR SHAPIRO: Joe, you add the sum of the
17 share in the merging firm.

18 MR. FARRELL: The sum of the shares of the merging
19 firms, I'll add that --

20 PROFESSOR SHAPIRO: -- as to the market.

21 MR. FARRELL: Although the product of the shares
22 of the merging firms was already in there as the delta.

23 PROFESSOR SHAPIRO: I believe the sum and the
24 product are the same.

25 MR. McFALLS: Is the log useful?

1 (Laughter.)

2 MR. FARRELL: The log is useful. I was thinking
3 of a tactful way to say that.

4 Thoughts?

5 MR. McFALLS: I mean as a practical matter, we
6 know when people, when our clients are likely to have issues
7 right away, and I think we use all these. What should you
8 use as a safe harbor, aside from the phone calls that you're
9 going to get from customers who are competitors, I see no
10 problem in applying all these tools. Assuming that you have
11 the data, these are done in the course of a day, so I don't
12 think you're really saving any time.

13 What's the most meaningful? Again none of these
14 are particularly meaningful at the end of the day, but if
15 you're going to use UPP, in the limited circumstances that
16 you've identified it makes sense to use this. It's clearly
17 an improvement over the arbitrary method of going through
18 market definition, but you have to realize that that's where
19 you're going to back into it.

20 As Dan said, at the end of the day, because you're
21 going to have all of these other sources of information that
22 you're going to use to back into it. If you used it as a
23 screen, you probably ought to modify it to reflect the fact
24 that you're not going to catch mergers that were fine under
25 the previous screen. And there are any variety of ways that

1 you can modify the UPP to make sure that you're not catching
2 mergers that, you know, were fine under the old screen,
3 unless you are able to do a respective showing that those
4 mergers weren't fine.

5 MR. FARRELL: I will note that of course we don't
6 do nearly that many retrospectives, we should but we don't
7 have the staff, but those retrospectives that have been done
8 are not very consistent with the idea that mergers that are
9 allowed to proceed are harmless.

10 MR. McFALLS: I'm not saying the mergers that are
11 allowed to proceed are harmless. I'm just saying are you
12 catching mergers that were fine under the HHI screens as
13 problematic under UPP. Soft drink mergers, from what I
14 remember, a Harold Saltzman study in the late nineties
15 showed some of that. But I think that's worth revisiting.

16 I don't think there is any problem or harm in
17 using these screens. And there could be harm to the
18 Agencies over time if you're expected to do this in every
19 case.

20 PROFESSOR RUBINFELD: I have a couple of comments.
21 First on the comedic side, I hope whenever I hear four-to-
22 three, three-to-two, I can't get a certain jingle out of my
23 mind. So I think: Four-to-three, that could be; three-to-
24 two, that won't do. So that matters to me.

25 On a more serious note, I do think that some

1 screening process is important because the costs of second
2 requests and mergers are now so high that the Agencies have
3 to find a way to screen. And when I left the Justice
4 Department, I got very interested in some of the more
5 complicated simulation methods, which you had to have at
6 least a second or a third request before you could finish.
7 So I devised, as some of you know, some software which is a
8 logit like variant that does a quick-and-dirty analysis of
9 simulation. And it's actually very similar in spirit, I
10 would say, to the UPP idea that Carl and Joe developed,
11 trying to use some simple rules of thumb that will get you a
12 ballpark estimate of what's going on.

13 I do actually, though, agree basically with what
14 Dan Wall said, and that is we don't have very much evidence
15 as to how accurately these models predict. I like to use
16 them not so much as predictors but as sort of ways to
17 evaluate robustness of results.

18 In the simulation model I like to use, I actually
19 modeled repositioning and entry along with the initial
20 estimate of competitive effects. These are all relatively
21 easy to do if you make some pretty strong assumptions.

22 In the end I like that device but not because it
23 tells me the merger's going to cause prices to go up by 6.7
24 percent, because I don't really know that, but it will tell
25 me exactly what to look at and it will tell me how strong

1 certain arguments have to be before I'm going to clear the
2 merger. I think qualitatively those methods are very
3 powerful.

4 MR. FARRELL: Harry.

5 MR. POPOFSKY: Well, I guess I will try to get a
6 word in modestly edgewise. I have never argued with the
7 good professor on my right, so I won't do so now, given his
8 wealth of experience. But I remain skeptical that you have
9 reliable-enough data or can get it without going into, as
10 you said, a second and a third request to really come up
11 with anything like a meaningful assessment of whether the
12 merger will substantially harm competition.

13 And I, for the life of me, do not yet know whether
14 simple screens in the sense of a revised HHI, for example,
15 if used would not pick up virtually all of the dangerous
16 mergers that one could identify with the refined models
17 which you speak of.

18 I know the HHIs need revision. I think there's
19 very little doubt that they have to be changed to reflect
20 much more of the actual practice and much more of the actual
21 risks to the economy from mergers, but until there is some
22 reason to believe that traditional HHI type of analysis, and
23 it's certainly more refined than four-to-three, but more
24 refined HHI analysis catches the bulk of that which puts the
25 economy at risk, I'm not sure internally one needs a great

1 deal more.

2 There is an enormous advantage that the
3 administration has over private parties in the
4 administrative process, and one can never ever look beyond
5 that. The cost advantage is immense. The fact is that the
6 transactions will fall apart if challenged, sometimes even
7 if there's a second request. And it seems to me that if one
8 can still use, maybe I'm a Neanderthal, something closer to
9 the historic concentration in HHIs, to make that first cut
10 before one goes into the more elaborate modeling, then
11 you've done what the public interest fairly requires.

12 I don't think the fallout is that great. I don't
13 think we'd be missing a significant number of dangerous
14 mergers.

15 MR. FARRELL: Can I just follow up? You
16 mentioned, you said modified or refined Herfindahls. Are
17 you talking about a change in the measure or are you
18 referring to changes the thresholds that are, for example,
19 described in the Guidelines?

20 MR. POPOFSKY: I was assuming that the thresholds
21 were the main thing. I'm not enough of an expert to work
22 with the measure itself. I was taking the measure as-is,
23 but the threshold seemed to me plainly out of whack.

24 MR. WALL: So a couple comments. First of all, to
25 answer the question about screening inclusion, exclusion

1 criteria, I would tend to start by looking for a measure of
2 the number of firms, because I think in the unilateral-
3 effects analysis a small number of firms is going to be
4 usually a fairly important part of it. And, I like actually
5 what Carl suggested, they're very simple of what the
6 combined share is.

7 I started practicing antitrust in 1980, so I was
8 in the first generation of people who had to learn how to
9 square market share numbers, and I still don't know why we
10 do it. I still don't understand what the utility is. If
11 there were a paperwork reduction act for antitrust, just not
12 having to square the numbers would be a good way to --

13 MR. FARRELL: It's because if you add up the
14 shares without squaring them first, you always get the same
15 answer.

16 MR. WALL: Okay. I would start with the number of
17 competitors and some sense of combined share.

18 I would proceed to ask what are the indications
19 that you have particularly close competitors.

20 Then in terms of the exclusion criteria, if you
21 will, what I would proceed to immediately is focusing on
22 repositioning, as I indicated earlier, because I think in
23 practice that's very often what makes a unilateral effects
24 story fall apart. It is easier to establish repositioning
25 than it is to meet the entry standards from just, if for no

1 other reason, that the person who's already in the market
2 has gotten certain assets that just need to be redeployed.

3 In a lot of the cases that I've been involved with
4 where we haven't gotten a second request or we've got it
5 through with Quick Look, or something like that, one of the
6 reasons is because an advantage from our side of the table
7 of unilateral effects analysis is if you can establish
8 quickly that either you're not particularly close
9 substitutes or that there's other people who could move
10 around pretty quickly, you have a good chance of just
11 getting out of jail right away, and we had quite good
12 experience with that in a number of cases. So generally
13 that's how I would approach it.

14 MR. FARRELL: So several of these suggestions,
15 including some of the ones that I raised, require you to
16 define a market before you can implement a screen or index,
17 or whatever you want to call it. In talking, Larry for
18 example, about how the Herfindahls might be a good way to
19 go, to the extent possible, what style of market definition
20 do you have in mind? Do you have in mind the market
21 definition as in the '92 Guidelines? Are you talking about
22 a more intuitive market definition? What do you have in
23 mind?

24 MR. POPOFSKY: Well, I think what I had in mind,
25 for purposes of this initial, internal, 'I've got a thousand

1 mergers, how do I deal with it,' was an intuitive market
2 definition. Every practitioner, it seems to me, sits down
3 with the client and asks: Who are your competitors. What
4 are the practical alternatives your customers have. Where
5 can they go to get product. You can construct an intuitive
6 market pretty easily from those conversations.

7 MR. FARRELL: And so can someone else.

8 MR. POPOFSKY: And so can someone else. I'm not
9 saying it's definitive, but I believe that you get a very
10 good, quick grasp on what becomes a market definition. You
11 can very quickly, whether you do it by just concentration
12 ratios, percentages, whether you do it by HHIs, you can get
13 a very quick handle on whether the merger seems to be
14 potentially risky before you ask, okay, what are the
15 unilateral effect risks here. Are they distinctive.

16 PROFESSOR RUBINFELD: And let me --

17 MR. POPOFSKY: I think in an oligopoly, my own
18 view is it's very hard to say what is unilateral and what is
19 coordinated. It seems to me you end up saying almost the
20 same thing in different guises.

21 Anyway, my view is: This is not that difficult.

22 PROFESSOR RUBINFELD: I was just going to repeat
23 something I said earlier because I think it's important
24 here. In many cases there's not going to be much issue
25 about what the market definition is, in which case I'm

1 comfortable with a sum of the shares, probably as well,
2 although I can square probably better than you can, Dan.

3 MR. WALL: A calculator, yes.

4 PROFESSOR RUBINFELD: Yes, I have a secret
5 calculator.

6 But there are a number of other instances where
7 the market definition debate starts to trump everything and
8 can lead to some perverse discussions and often second
9 requests that I think would be unnecessary.

10 An example that comes up a lot in my thinking is
11 in a lot of pharma cases one side of the issue will
12 typically like to define a market as the molecule, or even
13 narrower than that, and the other side will typically define
14 the market as every possible drug that might have some
15 therapeutic value. Now what's the right answer? Well, it's
16 just going to vary case by case, and sometimes we'll be able
17 to sort that out. Other times it's going to be very
18 difficult because it's a highly innovative, evolutionary
19 market.

20 But I've seen many cases where the effect of the
21 merger really didn't matter on where you drew that line. So
22 the advantage of some of the simulation methods or the UPP
23 concept, or all of that, is that it builds on focusing on
24 diversion and the impact of diversion and it doesn't build
25 directly on a narrow definition of a market.

1 I think we ought to just allow ourselves, I hope
2 in the revision of the Guidelines, the flexibility in those
3 cases to go that route. Most of the time it won't be
4 necessary, but when it is I think it'll save a lot of
5 trouble. Sometimes it'll make it easier to prosecute a
6 case, but a lot of other times it'll avoid a lot of cost for
7 the parties that are doing a merger.

8 MR. WALL: Some of you know what's coming because
9 I've made this speech many times before. There is a
10 practical side of all of this which is it would be great if
11 when the Agencies brought a merger challenge, they were to
12 prevail in court. And they are never going to prevail
13 without either giving market definition the primacy and
14 respect that it has under the case law or undertaking a long
15 and what I would predict would be difficult process of
16 reeducating the courts to move away from market definition
17 and accept these backing-into-the-market methods or direct
18 proof or direct simulations or something like that.

19 I personally think that I wouldn't advise path two
20 because I think it's going to be wasteful and it's going to
21 lead to a lot of unsuccessful cases given how embedded
22 market definition is in the law.

23 When Larry said you sort of a little bit of you
24 know when you see it at the beginning, that there's a
25 certain intuitive way that you can kind of tell what the

1 market is, Larry and I have spent our careers as litigators.
2 And one of the things that, like my mentor, Tom Rosch, that
3 you realize right away is that that first intuition you
4 have, based upon what seemed sensible as a market is
5 probably the market definition that has the best chance of
6 holding up in court, too. That it's going to be plus or
7 minus that something. It's going to be very, very difficult
8 to meet the burden of proof that you have if you try to
9 establish a much smaller market than that based upon price
10 discrimination or some backing-in methodology, or something,
11 You are just handing the merging parties a very, very potent
12 argument to defend the merger.

13 I know that there remain many people in the
14 Agencies who remain convinced that they were right in the
15 Oracle/PeopleSoft case. The case did not have a chance of
16 succeeding because of market definition being so difficult
17 to prove and establish. It was so difficult to sustain that
18 market definition.

19 This is how it's going to be for a long time. And
20 I just think the Agencies are making a fundamental mistake
21 if, through the Guidelines or whatever, they try to go in
22 other directions in order to wire around difficult problems
23 of market definition.

24 MR. McFALLS: Just one word, Danny. I think when
25 you say --

1 MR. POPOFSKY: I just want to say I like that
2 speech, however many times he's given it. And the only
3 thing I would add is I have a sliderule for him for his
4 mathematics.

5 (Laughter.)

6 MR. WALL: I have an abacus.

7 MR. McFALLS: Yeah. The only thing I'd say is the
8 backing-in process is not a model. It's just a process that
9 you go through as you're finding of facts. At the end of
10 the day you're going to have to make a decision about what
11 relevant market you think is correct.

12 All that said, does it really matter. If you're
13 going through the process of finding out what the diversion
14 ratios are with UPP, you're identifying who the competitors
15 are, unless of course you only have one diversion ratio and
16 it's from one merging party to another.

17 I mean if you find out what the diversion ratio is
18 with the other players, you are figuring out who else
19 constrains the parties. And I've got news, there are a lot
20 of defense lawyers who might like this approach because you
21 might find out there are a lot of people who use soap as a
22 substitute for shampoo or shower gel as a substitute for
23 shampoo. So at some point you're going to have fights down
24 the road about what a diversion ratio should actually mean
25 in this context and whether or not any of this matters.

1 MR. FARRELL: Okay. Let me turn to questions from
2 the audience. Tom.

3 PROFESSOR SHAPIRO: I believe it's on.

4 COMMISSIONER ROSCH: Thank you. Well, frankly, I
5 kind of come out a little bit in the middle because I do
6 think that there's a lot of the substantiality in our
7 statute. I think it does speak in terms of substantially
8 lessening competition. That makes market definition and I
9 think probably the product of the merging parties' shares,
10 Carl, the more relevant measure.

11 And I think it needs to be relatively high. But I
12 don't think it needs to be an upfront market definition. I
13 think it's one factor to be taken into account. And that,
14 frankly, is why I am inclined to think we can use the same
15 tests for unilateral effects that we use for coordinated
16 effects.

17 As I remarked at the very beginning this morning,
18 this is not a brand new idea. This is Professor Whinston's
19 idea. He suggested that basically what we're doing with
20 Section 1 of the Guidelines is that we are defining demand
21 elasticity, basically, or a demand curve, if you will.
22 We're identifying those -- a diversion ratio, Michael, if
23 you want to talk about it in that respect.

24 We're talking about what sellers think is going to
25 happen if they raise price appreciably, who are their

1 competitors, and what are their market shares. Basically
2 that's what we're talking about.

3 Now where I depart from you, Dan, is that to my
4 way of thinking when we're talking about unilateral effects
5 analysis, if we literally follow your paradigm, as I
6 understand it, if you have second and third firms whose
7 market shares represents ten percent apiece, but they divert
8 very substantially one from the other and back forth.
9 That's a problematic merger under the unilateral effects
10 theory. I don't think that should be the law. I agree with
11 the notion that you put out earlier, that substantiality
12 means something under our statute.

13 So I think that basically what has to happen is
14 you need to demonstrate, the Agencies need to demonstrate as
15 one of the factors, not the only factor, not the upfront
16 factor, but one of the factors they need to demonstrate is
17 that it's a, say, 40 percent at least, the sum of the
18 merging firms, the sum of the shares of the merging firms.
19 I would have no problem in making that a factor. And that
20 would be a screening device of the sort that you're talking
21 about, Larry, that would screen out the unproblematic
22 mergers and we wouldn't have to worry about those in the
23 hundred that we review.

24 But I resist the notion that we need to have that
25 as an automatic, upfront screening device in every case. I

1 don't think that that's the case. That's one very important
2 factor, but not the only one.

3 MR. POPOFSKY: If I could just comment, and it
4 relates a little bit to what Dan said, if you do the
5 anticompetitive effects analysis and back into a market
6 definition that way and if in fact that's the market
7 definition that corresponds with what you learn when you
8 talk to your clients, and they say who are your major
9 competitors, you end up in the same place for presentation
10 to the court. You then have a market definition you can put
11 upfront to the court and say: This isn't just some
12 esoteric, jerry-built, strange language, Oracle-style
13 market, this is a real market, even if it is more narrow
14 than people generally tend to think about it.

15 The problem is the perceived sense that courts are
16 reluctant to accept narrow markets. If you back into the
17 market definition, it seems to me you have potentially a
18 defensible, upfront market definition you can go to court
19 with, but it ought to come to the same thing. It should
20 make no difference whether you do it one way or the other.
21 You've got to have a meaningful market definition.

22 And I, for one, believe that a percentage screen
23 is awfully useful, just like it is in Section 2
24 jurisprudence, where we're also dealing with monopoly power
25 or abuse of dominance. There's no reason why Section 7 has

1 to be so completely divorced from Section 2. Both deal with
2 unknowns. One is what will happen tomorrow if they merge;
3 the other is what would happen if we didn't have this
4 conduct we allege to be anticompetitive. Both deal with
5 unknowns and both deal with attributes of alleged dominance.

6 And I think if things like 30-percent screens work
7 for tie-ins, exclusive dealing, they ought to be equally
8 utilitarian in merger analysis.

9 MR. WALL: So one comment is that one of my
10 reactions to this notion of backing into the market
11 definition is a very practical one, is that when I see it
12 proposed, it more often than not ends up resulting in a
13 market that is narrower than that intuitive one that you
14 see. After a while, as creeped out as I am by the idea of
15 using body wash on your hair, I don't see that happen quite
16 as often as I see a market that it's got to have at least
17 these five players, now only has these three, because we
18 backed into the market.

19 I can back into a conclusion from that, which is
20 the utility of this method is primarily to narrow markets.
21 Again, not to be repetitive, but I just say that when you do
22 that and then you try to go to court, you've got one hand
23 tied behind your back because you have handed the merging
24 parties the argument of: Hey, where is the other two guys
25 that walk, talk, and quack like competitors. And to say,

1 well, yes, I mean the documents say they compete and the
2 parties say they compete, but I backed into the conclusion
3 that they didn't compete is unlikely to be effective.

4 PROFESSOR RUBINFELD: I was just going to say, so
5 Dan can sleep better tonight, the cases I have in my mind
6 are exactly the opposite where looking at some of the
7 historical data empirically has suggested to me some
8 relationships, certain degrees of substitution that I hadn't
9 thought about. I can think of a couple cases where when I
10 would talk to the parties, they would say: Yes, that's not
11 in our upfront documents, but now that you mention it there
12 is substitution.

13 One classic example had to do with the merger of
14 cereals. Some of you know I was involved with it long time
15 ago and I found empirical evidence that the cereals that
16 kids eat substitutes for the cereals that adults eat. And
17 that led to a broader market and to me actually testifying
18 that adults were once kids. So you never know what will
19 happen when you back into market definition.

20 MR. ZONA: There's a fundamental tension between a
21 SSNIP-defined market, it seems to me, which tend to be
22 narrower, as I look at them, and the markets that get
23 accepted by the courts, with the exception of *Whole Foods*, I
24 suppose, the District Court might get it right. So it seems
25 like all of you have sort of addressed this point in a way,

1 but should that be addressed in the Merger Guidelines, in
2 any revisions to the Merger Guidelines?

3 MR. McFALLS: I've got one comment to make. I
4 think somebody in the comments to the request for comments
5 pointed this out. It's pretty obvious that the SSNIP test
6 presumes that the merging parties -- the hypothetical
7 monopolist test is that you could impose a unilateral price
8 increase of x percent, five to ten percent. Obviously if
9 you've reached that conclusion and the merging parties are a
10 monopolist and there would be a unilateral effect, so in
11 that sense you've already answered the question for price
12 increases at least that are five percent and above in the
13 market definition.

14 So theoretically, the Unilateral Effects Section
15 in the differentiated-product market context should only
16 cover mergers that result in a zero- to five-percent price
17 increase. At some point it might be nice to iron that
18 inconsistency.

19 COMMISSIONER ROSCH: One last comment. Dan, I
20 recognize there's a substantial body of case law out there
21 that does require an upfront market definition. By and
22 large, those are older cases. However, *Baker Hughes* was
23 exactly the opposite. It suggested that what was really the
24 real inquiry in these cases should be competitive effects.

25 So I'm not quite as dour about the Agencies'

1 chances in these cases as you are if we eschew an upfront
2 market definition and simply treat it as an important
3 consideration but just one of a number of them.

4 PROFESSOR SHAPIRO: I would also just jump in
5 there. The upfront, it's one thing to say if we went to
6 court that we would tell the court in the complaint: Here's
7 the relevant market, here's the line of commerce, that's
8 where we claim there's an effect. That's very different
9 than saying the first step in a merger investigation, either
10 before or after a second request, is going to be to figure
11 out what the relevant market is in order to figure out
12 effects. Very different.

13 MR. WALL: I agree with that completely. Behind
14 the closed doors of the Commission you obviously can do it
15 in whatever order you want. It is just that if the end
16 product of that is a conclusion that then has to be
17 articulated by reference to a traditional market definition
18 to go get an injunction, have that in the planning cycle
19 somewhere.

20 PROFESSOR SHAPIRO: Thanks for the tip.

21 (Laughter.)

22 MR. FARRELL: Any of the panelists want to issue a
23 very brief closing?

24 MR. POPOFSKY: Well, I was just struck by one
25 thing that Commissioner Rosch mentioned, because I come from

1 an era before there was such a thing as a unilateral effect.
2 It wasn't in *Areeda* when I was a student. If it wasn't --

3 MR. WALL: They actually existed, we just didn't
4 know what to call them.

5 MR. POPOFSKY: Well, they didn't exist. If it
6 wasn't in *Areeda*, that was the truth.

7 After all is said in done it is not clear to me
8 that we have moved a great deal forward dividing the world
9 into two halves. I mean your opening question suggesting
10 there's a very large gray middle ground suggests the same
11 point, that perhaps, just perhaps a unitary look at the
12 market as a whole, concentration ratios however you want to
13 do them, suffices to catch all the potential anticompetitive
14 effects, and that the Guidelines ought to reflect that and
15 come at it that way, but then identify the potential kinds,
16 kinds of anticompetitive effects that can occur, whether
17 they're called coordination, whether they're called
18 unilateral, whether they're called something in between.

19 I guess I'm not persuaded, as I reach antiquity,
20 that *Areeda* had it wrong in 1962.

21 MR. FARRELL: Thank you very much.

22 (Applause.)

23 MR. FARRELL: Let's take a 15-minute break and
24 start again at 3:43

25 (Recess taken from 3:28 p.m. to 3:49 p.m.)

1 the some of the strategies of at least three companies that
2 are important in the tech sector.

3 The second is the topic. So the topic is:
4 Dynamic Markets and Innovation. And it's not a coincidence
5 that we decided to hold this panel here in Silicon Valley at
6 Stanford. That has sort of obvious reasons. Of the five
7 workshops and I guess some 20 panels total we're having over
8 these two months, is this the one devoted to this topic. So
9 that seems to be terribly important.

10 Let me just introduce the members of the panel in
11 the order actually I will ask them to speak, just with brief
12 introductions. First in the middle here, more or less:
13 Mark Chandler, who is the Senior Vice President and General
14 Counsel at Cisco Systems;

15 Next we'll hear from Greg Sivinski, who is a
16 Senior Attorney and handles antitrust at Microsoft and has
17 extensive experience with deal-making and deals from the
18 Microsoft perspective;

19 Third will come Bruce Sewell, who's General
20 Counsel and Senior Vice President, Legal and Government
21 Affairs at Apple, who I've had the pleasure to work with
22 extensively over the years, before I joined the Government;

23 And then we will have two academics: David Teece,
24 my colleague and friend from the University of California
25 Berkeley, the Thomas Tusher Professor in Global Business;

1 and, lastly, Tim Bresnahan, my friend as well, Landau
2 Professor of Technology and Economy at Stanford University.

3 Let me set up the topic with a few minutes, as I
4 did earlier this morning for the previous panel and Joe did
5 for the panel we just concluded.

6 So innovation and dynamic markets. These are
7 actually potentially two different topics, closely related.
8 We have some markets where markets are changing for reasons
9 other than innovation: Declining industries. Some firms
10 happen to be in trouble, other firms are up and coming. So
11 in principle we can distinguish the two. In many cases the
12 reasons for the dynamics are innovation and technological
13 change, so they fit together very well. But I think we can
14 talk about market dynamics even when there's not substantial
15 innovation. In some cases we do see those markets, so I
16 just want to flag that distinction.

17 We will focus, to be sure, on innovation, though.
18 It is striking, one might say glaring, that innovation is
19 virtually absent from the Horizontal Merger Guidelines.
20 There are some general nods in a couple of spots to nonprice
21 competition and that you've heard that today, it's of
22 interest in merger review. This can, in principle, be
23 product quality, service, product variety, as well as
24 product movement, R & D, innovation. But there is very
25 little there to indicate how innovation effects would be

1 analyzed or how industries with substantial technological
2 progress would be evaluated differently than more static or
3 stable industries, let's say.

4 And, unfortunately unlike many other areas, the
5 Commentary from 2006 does not provide a great deal of
6 additional material on this either. It certainly mentions a
7 number of cases where innovation has come up, but does not
8 give a lot of guidance, so we're in this situation where at
9 the same time we've got this, let's say, omission or very
10 little that said there's a widespread recognition that
11 innovation is king, if you will. Somebody said you look at
12 the Guidelines, it sounds like pricing is king, but many of
13 us have said or recognizing that it's become somewhat of a
14 mantra, actually, that innovation is the main driver of
15 consumer benefits of economic growth over the medium to long
16 run, at least in a great many industries and probably the
17 economy as a whole.

18 So we've got this terribly important dimension of
19 competition that is relevant for merger analysis, but
20 virtually nothing in the Guidelines. So that seems like an
21 opportunity for improvement if we're going to revise the
22 Guidelines.

23 I would note a particular article that I can't
24 help but mention. One of the members of our working group,
25 the working group of six members between the FTC and DOJ, is

1 Howard Shelanski, who is at the federal Trade Commission,
2 and he has a fine article with Michael Katz from 2007 in the
3 *Antitrust Law Journal* entitled "Mergers and Innovation." So
4 I find that useful and instructive.

5 They mention two types of things to think about
6 that I think they put good labels on. One they call
7 "innovation impact," which means if innovation is happening,
8 the industry or market is changing in more or less
9 predictable ways, such as a new generation of technology is
10 going to arrive in a year or two and will be in products.
11 That should be accounted for in how we think of forward-
12 looking merger analysis, and how do we do that as opposed
13 to, say, as some sort of static or backward-looking analysis
14 or review-mirror analysis based on historical market shares.
15 So that's one set of issues.

16 And the other they call "innovation incentives,"
17 how will the merger affect the incentives of the merged
18 firms or perhaps other industry members to engage in
19 innovation, to spend money in R & D, to be motivated to
20 improve their products.

21 We don't need to use those labels, but I thought,
22 if nothing else, out of respect for Howard, who doesn't
23 happen to be here today, I would mention that and I think it
24 frames some of the questions.

25 Now the fact is the Agencies look a lot at

1 innovation, impact and incentives, even though the
2 Guidelines are, if not silent, very spare in discussing
3 these issues. The question before us is: Can we say more?
4 Can we as the Agencies describe what we do? And today how
5 is this practice perceived, reflected outside the Agencies,
6 and what would be good things to say if we take this on?

7 Now I would ask everybody not to set up any
8 strawman here. The strawman would be: You calculate
9 Herfindahl, it's totally static, you don't look ahead, and
10 that's bad. Well, that would be bad, but it's not what we
11 do. And the Guidelines don't say we do that. They just
12 don't say what we do very much in dynamic settings.

13 So I think people who have practiced before the
14 Agencies or read competitive impact statements or other
15 materials such as speeches would recognize that we try to
16 look ahead, we try to reflect the dynamics of an industry,
17 and the question is: How do we do that? What are the
18 tools? How well do we do? Can we articulate that?

19 So I would hope the conversation would go in that
20 direction. We don't do a static analysis. We don't ignore
21 nonprice competition. But they require tools and issues
22 regarding evidence that are different than more of a static
23 pricing analysis that is so heavily reflected in the
24 Guidelines.

25 I want to mention one case, just I again find it

1 useful, as I did this morning, regarding price
2 discrimination to put one specific fact pattern out there,
3 recognizing it's just one. There are many different fact
4 patterns. But if people want to refer to it or the audience
5 here, just to have something in your mind, and this is the
6 FTC's case of *the Thoratec - HeartWare* merger that they
7 challenged and blocked last summer. So this case fits into
8 what I like to think of as a disruptive-entrant fact
9 pattern, where the incumbent, this was Thoratec, in this
10 particular case the product was left ventricular devices
11 which are surgically-implantable blood pumps. I hope we
12 won't have to worry too much about the details of these
13 products. But they're critical for people with very serious
14 heart problems who cannot get a heart transplant.

15 And the FTC found, alleged that HeartWare was the
16 only significant threat to Thoratec's continued dominance of
17 this market for this product. And they had evidence in
18 terms of FDA approvals that were expected within a few
19 years, and other potential entrants into the market were
20 further behind or less likely to succeed in entering.

21 So in that case there was no current, as far as I
22 know, product market competition between the two, but this
23 was -- you could call it potential-entrant case or a future-
24 product market case. And obviously it relates to innovation
25 effects. Although, as I understand it, a lot of the

1 innovation had already been done except there were still
2 trials in bringing it to market. That part of the
3 innovation process remained to be done.

4 We have a number of cases. I think if you look
5 back over both Agencies' portfolios where we have that type
6 of pattern, an established firm, a disruptive entrant, and
7 where we worry about the acquisition merger between those
8 two.

9 So maybe that's a noncontroversial fact pattern.
10 That would be interesting to know that. Then that would
11 make it easy to include that, but I suspect there will be
12 issues surrounding that type of fact pattern, how would we
13 analyze it. How would we determine that that fact pattern
14 warranted a challenge versus not. And of course again
15 that's just one of a number of patterns that can arise.

16 That happens to be in the medical device industry.
17 I realize none of our industry representatives here are from
18 medical devices. Happen to be from the tech sector, so it
19 may be somewhat less relevant because you don't usually have
20 FDA approval for software and hardware devices, so far as I
21 know. But hopefully the conceptual framework will still be
22 helpful in terms of disruptive entrants and industry change.

23 So, Mark, please go first.

24 MR. CHANDLER: Thanks very much, Carl.

25 As one who doesn't even play an antitrust lawyer

1 on television, it's with some trepidation that I'm going to
2 offer a few comments regarding the Horizontal Merger
3 Guidelines. Hopefully even a generalist like me can add
4 some useful perspective, though I note your comment that
5 there are people here from real companies made me think
6 maybe I'm supposed to offer sub-analytical, anecdotal
7 comments that will be strawmen in their own, so I'll try to
8 exceed at least that low bar.

9 PROFESSOR SHAPIRO: I didn't have that in mind at
10 all.

11 MR. CHANDLER: Okay. Cisco believes that strong,
12 properly-enforced, and transparent antitrust laws are
13 critical to continue technology innovation. In areas of
14 standards, for example, antitrust law must play a critical
15 role in promoting innovation and diffusion of technology.
16 We strongly support your efforts and the Commission as well
17 to drive greater transparency into the standards process and
18 to take to task those who use standard setting as a game for
19 the enshrinement of private economic advantage, and that
20 happens all the time. We see it every day.

21 By the same token, clear and relevant Merger
22 Guidelines transparently applied are critical in a dynamic
23 environment where acquisitions, along with independent
24 development and partnerships, are key components to growth
25 and success.

1 My company's currently celebrating its twenty-
2 fifth anniversary. We believe that the foresight to
3 identify coming market transitions, the ability to mobilize
4 our internal R & D resources, or to acquire technology from
5 third parties to enable us to move into developing or
6 adjacent markets has been a key component of our success.

7 We've completed 136 acquisitions over the last 15
8 years. Mergers necessarily involve guess work. Just as
9 Cisco makes bets on market trends in deciding whether and
10 when to acquire, so too are the Agencies predicting future
11 effects based on incomplete information. I appreciate the
12 opportunity today to add our perspective to how those
13 assessments can be made with the greatest degree of
14 accuracy, for the sake of all parties involved.

15 We acquire in order to enhance our ability to
16 compete in new market areas. Not all of those acquisitions
17 turn out as planned. While mergers can fail because of
18 misexecution, we've also seen the technologies that we
19 thought would be relevant simply were superseded. I joined
20 Cisco in the \$5 billion acquisition of StrataCom in 1996,
21 where I had been general counsel. StrataCom was a leader in
22 wide area ATM, or asynchronous transfer mode data
23 transmission.

24 While ATM still played an important role, in the
25 decade following the acquisition ATM was largely superseded

1 by advances in the use of internet protocol as the common
2 language for internet data transmission.

3 Other examples abound. Take the AOL-Time Warner
4 deal. Now it's remembered as one of the most colossal
5 failures of strategy in business history, at the time though
6 there was great concern about the pernicious impact the deal
7 would have on development of the broadband internet, and the
8 companies had to fight hard to win approval, a process that
9 took almost a year.

10 Though I noted in Monday's *New York Times* Bob
11 Pitofsky pointed out that the Commission's economist thought
12 the deal made no financial sense from the get-go, why did
13 they worry? As Ken Auletta points out in the book *Googled*,
14 AOL and Time Warner just did not count on Sergey Brin and
15 Larry Page coming along and tearing down the walls around
16 AOL's garden.

17 My point isn't to criticize any particular Agency
18 enforcement decision, but rather to emphasize the quip that
19 I think we heard earlier today, that it's tough to make
20 predictions, especially about the future.

21 The Guidelines are especially relevant to this
22 since the party's view as to whether a second request will
23 be issued can be outcome-determinative in deal negotiations
24 in my industry. When a company's most critical assets drive
25 home every night, the uncertainty for protracted delay can

1 be deadly. Now as a result the analysis we undertake when
2 we're looking at a transaction isn't just the likelihood of
3 approval or concern about the cost of complying with a
4 second request, but how long approval will take. This has a
5 direct impact on whether some transactions are pursued,
6 since parties may not want to pursue a deal that puts
7 employee retention at risk.

8 This is especially true here in Silicon Valley,
9 where California's pro competition employment law rules,
10 combined with a density of opportunity, facilitate easy
11 employee mobility. So any change in the Guidelines should
12 drive toward predictability and clarity.

13 How can both companies and the Agencies increase
14 the odds that we get the analysis correct? To be sure, the
15 laws of economics are not repealed or suspended for high-
16 tech companies or dynamic industries, and robust,
17 traditional economic analysis must remain the essential tool
18 of merger review. The rigor of the economic method allows
19 for incorporation of factors in the analysis which may have
20 been historically undervalued but are nonetheless relevant.
21 The challenge in some cases will be whether there are real
22 world measurable values or whether proxies need to be used
23 and the value of those proxies.

24 I believe that in high-tech, dynamic markets the
25 focus should be on the anticipated competitive effects of

1 the merger, keeping in mind that the speed of change, the
2 disciplining power of customers in an environment where
3 disruptive innovation can occur with breathtaking speed and
4 regularity, are going to be critical factors.

5 In an industry where Moore's Law reigns and price
6 performance ratios are constantly falling, an analysis based
7 on the power of participants to raise prices seems at least
8 to industry participant to miss the point. Let me make this
9 clear: Raising prices has in my experience never been a
10 part of any acquisition discussion that I've ever seen at
11 Cisco; fear of technological obsolescence or the opportunity
12 to create new markets with disruptively-lower costs to
13 consumers almost always is.

14 The current Guidelines leave room for the Agencies
15 to look to the future in reviewing deals in dynamic markets
16 and to discuss the right factors. To my mind, however, the
17 presumption should be reversed. At the simplest level, the
18 analysis proposed in Section 1.521 of the Guidelines should
19 be the rule, not the exception, when looking at certain
20 types of transactions.

21 In high-tech dynamic markets the presumption
22 should be that historical market shares are not a reliable
23 predictor of the future. Change simply occurs too quickly,
24 and absent regulatory tariff or other artificial barriers to
25 trade is immediately global in scope.

1 Backward-looking market shares may be a
2 consideration, but the analysis should neither start nor
3 stop there. Products move from conception to design to
4 worldwide customer availability in months. Product
5 modifications and improvements can be implemented nearly
6 instantaneously to respond to a competitive threat, to seize
7 a market opportunity.

8 Because premerger concentration is likely to be a
9 poor predictor of postdeal competition, then merger review
10 in a dynamic market needs to focus on effects. It would be
11 helpful if the Revised Merger Guidelines were more explicit
12 with respect to the types of information and sources that
13 are acceptable to demonstrate reasonably-predictable
14 effects. Are internal strategy documents an acceptable
15 source, industry publications, the views of informed
16 customers? We believe each of these has a place in the
17 evaluation of mergers in a dynamic industry like ours.

18 Mergers in dynamic markets also differ from
19 traditional markets with respect to the phenomenon of
20 convergence. Convergence occurs when companies with
21 different strengths identify the same set of applications as
22 adjacent markets. This can occur extremely quickly as what
23 seem like distinct product markets and participants suddenly
24 come to compete. Current examples include convergence of
25 networking and computing, telephony and computing,

1 convergence of still and video cameras with multifunction
2 phones.

3 Cisco's emergence this year as a competitor in the
4 corporate data center, with the potential for dramatic
5 efficiencies and benefits to customers, is based on
6 deploying networking technologies we already had, augmented
7 by acquisitions and our own developments. Yesterday's
8 announcement by two very large industry players, one of whom
9 is represented on this panel, of new data center and cloud
10 architectures and products, was partly driven by our entry,
11 if the press reports and analysts' commentary today is to be
12 believed.

13 Similarly, it would not have been conceivable
14 several years ago that consumers would chose one
15 multifunctional device, like an iPhone, over multiple
16 devices for photos and video. But today millions of people
17 are doing just that. Five years ago it was unlikely that
18 Palm, RIM, Nokia and Motorola viewed Apple as a competitor.
19 Two years ago it's equally unlikely that Apple viewed Google
20 as a competitor. No merger of competitors in 2006 would
21 have stopped the impact of the iPhone.

22 Structural merger analysis, with its reliance on
23 historical concentration ratios can be outright misleading
24 in industries marked by rapid change and convergence. If
25 there are indications that convergence is occurring or

1 likely to occur, the Agency should more expressly
2 incorporate into the analysis the likelihood that new market
3 participants and market dynamics will constrain potential
4 anticompetitive effects of a proposed merger.

5 The competitive-effects analysis should therefore
6 look closely at postmerger incentives, including the market-
7 growth assumptions and valuation assigned to the acquired
8 company or assets where an asset makes sense financially
9 only if there's high-market growth, and, in fact, acquired
10 companies seek to monetize for themselves the synergistic
11 values of the transaction that would come out of rapid
12 growth. If that's the valuation that's on the acquired
13 company, steps that would frustrate market growth, by
14 working to constrain output or increase prices are therefore
15 contrary to the acquirer's long-term interest in recovering
16 that investment, even if they might increase short-term
17 profits. In those cases the Agency should be receptive to
18 the argument that the acquirer will be constrained from
19 exercising postmerger power by the need to make those
20 expectations real.

21 Likewise, in predicting competitive effects,
22 reputational cost to acquirers of maximizing short-term
23 profits are relevant. For example, in networking
24 industries, in my industry, customers place a high value on
25 interoperability, in compliance with industry standards.

1 Our policy generally has been not only to freely license but
2 to license for free anything that we propose as a standard.

3 Customers view deviations from standards and
4 creation of noninteroperable products with suspicion.
5 Customers don't want to be trapped into using products for a
6 senior vendor, and recognize the role that interoperability
7 plays in protecting them from opportunistic behavior.
8 Acquirers with a reputation for creating standard-compliant,
9 interoperable products -- I put myself in that category --
10 are unlikely to put their reputations at risk for the sake
11 of short-term economic interest in one product segment.

12 Standards themselves are important for evaluation
13 of entry barriers. Where standards exist, where industry
14 participants play by the rules -- not always the case -- no
15 competitor can exclude entry by refusing to license.
16 Facilitating entry into industries like networking and
17 computing, which rely on strong standards, is why both
18 Agencies should remain vigilant in policing abuses of the
19 standard development system.

20 All participants in this discussion recognize the
21 importance of innovation for consumer welfare. For many
22 companies in dynamic markets, research and development costs
23 may be high. R & D efficiencies gained through merger may
24 be significant, especially in areas where marginal costs are
25 low relative to price. Nonprice effects like these must be

1 taken into consideration when assessing mergers in dynamic
2 markets.

3 The Guidelines have stood the test of time,
4 provide a solid framework for merger review. They do for
5 us, I know they do for many, many others as well. I hope
6 I've provided some food for thought for how they can be even
7 more relevant for dynamic industries.

8 PROFESSOR SHAPIRO: Thank you, Mark.

9 Let me just, so everybody who doesn't have Section
10 1.521 memorized, it refers to changing market conditions.
11 It says -- and this will be relevant for the discussion to
12 come, talks about "How market" -- "Concentration of market
13 share data of necessity are based on historical evidence,
14 recognize as things change," and then says, "The Agency will
15 consider reasonably-predictable effects of recent or ongoing
16 changes in market conditions and in interpreting market
17 concentration and market share data."

18 And I think you said that's the norm, that you
19 would go down the route, and the question is how would we do
20 it, and so forth. Or a question I put on the table.

21 Okay. Greg.

22 MR. SIVINSKI: Well, thank you.

23 I agree with almost everything he said. In fact,
24 I think what I'll do is carefully go through my comments,
25 prepared comments, and try to avoid repeating much of what

1 he did say. Mark did an excellent job kind of nailing the
2 tech industry point of view on dynamic industries and the
3 role of innovation in dynamic industries.

4 I want to step back a little bit and talk about
5 the Guidelines, just briefly.

6 They've proven to be a very durable guide for
7 practitioners and for the last many years. As an inhouse
8 practitioner, I certainly appreciate guidance that's clear,
9 that's concise, and that's understandable not just to me as
10 a lawyer but to business clients who are being tasked with
11 the very difficult choices they face often when looking at
12 mergers.

13 Consistency and predictability in that process are
14 key, and any changes should be weighed against the risk that
15 consistency and predictability will be reduced.

16 I share the views of others, including some here,
17 that the current analytical framework is basically sound,
18 but that the Guidelines should be revised in a few key areas
19 to reflect developments and merger analysis in recent years
20 and, more importantly, to reflect the types of issues that
21 the Agencies are currently facing that they didn't really
22 face in great numbers, say, 15, 20 years ago.

23 Overall I believe the Guidelines should continue
24 their focus on the analytical framework and on the basic
25 steps of merger review. Transparency in that regard is a

1 very good thing. The Guidelines should not, however in my
2 view, try to provide any detailed explanation of a
3 particular analytical technique. If that technique is
4 untested over time or is only used in certain cases or is
5 simply experimental.

6 Doing so risks enshrining one technique over
7 another, and I think that's an incorrect assumption to draw
8 based on the flexibility that the staff likes to maintain
9 and in what tests and analytics it will apply in any given
10 case. It also risks enshrining them in a way that could
11 lead to false positives, false negatives in the way we look
12 at cases.

13 Given that the data for one or more of the complex
14 economics tools is simply not available, this would greatly
15 diminish the value of the Guidelines as a resource for
16 advising clients on a given merger.

17 I can tell you that I have read Carl's paper on
18 upward pricing. I think I understand it and I also think
19 that I could never find the data for it without a great deal
20 of effort in my industry. That presents a problem. Any
21 time that I'm asked to advise a client on the likely outcome
22 of a merger, more detailed explanations of specific
23 techniques that may apply in a particular case can be, I
24 think, better provided through the commentaries, the
25 speeches, and other outlets that the staff and the DOJ and

1 the FTC have for making those kinds of determinations.

2 Second, I think the Agency should stick to the
3 Guidelines current analytical starting point, based on
4 market definition and market concentration. These are well
5 known and predictable concepts and allow us to reach an
6 initial assessment of a merger. I was struck by what Larry
7 Popofsky had to say earlier. I thought he was exactly right
8 that there is an intuitive ability, if you've been in an
9 industry long enough, if you talk to your clients, if you
10 understand their business, you can reach an assessment very
11 quickly based on the current Guidelines' focus on market
12 definition, how that merger may be viewed, at least
13 initially by the staff.

14 There's no question that businesses understand
15 that should a deal go forward, a more detailed competitive-
16 effects analysis is going to occur, particularly if it's a
17 difficult deal. But we shouldn't have to derive cross
18 elasticities or diversion ratios or margins as a first step
19 to forming an opinion about whether a merger is in fact
20 going to raise significant issues.

21 So I applaud the question that was asked earlier
22 about what are the simple screens that we can employ that
23 allow us to advise our clients in deals where there is a
24 horizontal overlap, where there may be some concern. These
25 things do provide a good basis for making at least some

1 initial determinations. And I'd echo what Mark said, that
2 deals don't get done in this business based on the threat of
3 a second request. So clarity, simplicity, and
4 predictability are really paramount to our clients.

5 That said, I agree that there's room to improve
6 the current Section 1.5, which is flexible enough to
7 accommodate considerations beyond market structure, but
8 could do more to explain why market shares and market
9 concentration are measured in markets experiencing
10 significant technical change.

11 I would note, I don't have a solution for you. I
12 think it's a great idea that the Guidelines should include
13 some discussion of techniques for measuring shares in
14 dynamic markets. I think that could add significant
15 additional value to the Guidelines as a predictive tool and
16 make it something that's really useful to us in advising our
17 clients.

18 Then, third, the Guidelines today distinguish
19 between fixed and marginal cost. In practice, the Agencies'
20 tend to credit savings and marginal costs as more likely to
21 influence price.

22 You've asked and the Agencies have asked whether
23 any cognizable cost reduction is relevant and if it's likely
24 to generate benefits for customers in the foreseeable future
25 and whether the Guidelines should be updated to address

1 these nonprice effects. We think the answer is most
2 definitely yes.

3 The guidelines should place a greater emphasis on
4 the benefits to consumers that can result from merger-
5 specific savings in fixed cost. Current Agency practice
6 takes a skeptical view of fixed-cost efficiencies and, as a
7 result, Agencies often have failed to fully account for the
8 nature of competition in industries like software, in which
9 fixed costs are substantial.

10 The software industry as a whole is characterized
11 well by intense dynamic competition. Mergers that reduce
12 fixed costs increase incentives to invest in R & D, and
13 innovation. Moreover, because fixed costs in the long run
14 are variable, reductions in fixed costs today can generate
15 significant real savings in the long run as well.

16 Finally, I'd like to stress that R & D in
17 particular is important in our industry. Today the
18 Guidelines note that efficiencies relate to R & D are
19 potentially less acceptable to verification and my lack
20 short-term direct effect on prices. Consequently, they get
21 pigeon-holed as delayed benefits and given less weight.
22 It's ironic, I think, that when you look at the internal
23 documents from our companies that the staff will see in many
24 of these mergers, you will find that in fact it's the
25 principle reason why we're doing the deal.

1 So I think it's a reality of our transactions.
2 It's something that should be looked at more carefully. I
3 think the anecdotal evidence, both from the market, from
4 witness interviews, should play a great role in determining
5 the importance.

6 We think it's time to take a different approach
7 and recognize that innovation is a critical component of
8 growing our economy and that R & D efficiencies that spur
9 information are a key factor in emerging from the current
10 economic crisis.

11 Focusing on reducing marginal costs alone give
12 short shrift to the point that change and fixed costs of
13 innovation may determine whether that innovation occurs or,
14 more importantly, some other innovation could happen at the
15 same time. This has an obvious consumer welfare benefit in
16 both and the short long-run.

17 In short, I believe that merger policy unduly
18 focuses upon reduction of marginal costs over the potential
19 for fostering innovation, and that that risks missing the
20 point in missing the forest for the trees.

21 Thank you very much.

22 PROFESSOR SHAPIRO: Thanks so much, Greg.

23 Bruce.

24 MR. SEWELL: Thank you. I feel like I should
25 offer some sort of disclaimer first, that having now

1 listened to my two industry colleagues, we did not collude,
2 we did not prearrange this, but, as you'll see, there's a
3 tremendous amount of overlap. Perhaps it's of note that
4 this is may be one of the few times that these three
5 companies are in substantial agreement about anything.

6 As a corporate representative rather than an
7 economist or a practitioner or a regulator, I'm going to try
8 to keep my comments to areas where I have at least a little
9 bit of experience and offer you kind of a view-from-the-
10 trenches approach to this. Hopefully that will be of some
11 value.

12 I have a couple of general comments and then some
13 specific suggestions. I'm going to bounce around a bit, but
14 we can come back to any of this in the Q and A.

15 So let me start with the very simple proposition
16 but one that I think is fundamental and should underlie any
17 analytical framework in this area. Innovation is a good
18 thing. It's good for companies. It's good for consumers.
19 It's good for countries.

20 Technology is not a treadmill. It's a staircase
21 where each step rests on the ones that proceed it, but each
22 step also advances the state of the art and advances the
23 consumer welfare. Technical innovation produces new
24 opportunities, new wealth, and new consumer benefits. So at
25 the most basic level the Merger Guidelines should support

1 acquisitions that are likely to increase the pace of
2 innovation and be critical of or suspicious of acquisitions
3 whose goal or affect may be to delay the pace of innovation.

4 The impact of an acquisition on price,
5 particularly in the short Term, is not necessarily a good
6 proxy for impact on innovation, which at the end of the day
7 may be the more important and significant factor in consumer
8 welfare.

9 A merger between two powerful R & D firms that
10 produces a new produce with ten times the utility of
11 products in the premerger market is desirable even if the
12 price of the new device may be as much as two or three times
13 the price of the predecessor products that existed in the
14 market. However, under the current enforcement model, it's
15 not at all clear that such a merger would be approved or at
16 least approved in the short timeframe required by companies
17 competing in a highly-dynamic market environment. Let me
18 stress and reiterate what both of my colleagues have said
19 previously, that the issue of a second request is in many
20 cases a determinative decision in whether to pursue a
21 merger.

22 A quick point about what it's like to operate in
23 the kind of markets that Apple operates in. To do this, let
24 me pick up on a construct that was raised by David and Greg
25 in their responses, their written comments.

1 The implication of dynamic versus static markets.
2 The world in which most if not all technology innovator
3 companies operate is characterized by very short product
4 lifecycles, rapid deployment of new features and
5 functionalities, and the routine emergence of new and
6 completely disruptive technologies.

7 In short, it's commercial chaos. A potential
8 merger between two large distributors of music by compact
9 disk would have looked very different one year before the
10 introduction of the iTunes store than it would one year
11 after the introduction of that service.

12 By contrast, merger analysis works best in markets
13 with unchanging, undifferentiated products, and costs that
14 are affected more by scale than by changes in technology or
15 a business model.

16 Rapid innovation complicates traditional merger
17 analysis by severing the continuity between pre and
18 postmerger market definitions; by making it harder to
19 identify potential competitors and new entrants; and by
20 rendering the hypothetical monopolist, the SSNIP test,
21 relatively useless, because in dynamic-technology markets,
22 particularly the ones that my company operates in, feature
23 differences tend to be far more important than a five- to
24 ten-percent price differential.

25 Switching gears for a second. With respect to the

1 current Guidelines themselves, and with all due respect, we
2 have today what programmers would call spaghetti code. To
3 execute the analytical routines, you have to apply one patch
4 after another. The end result is overly complex and hard to
5 work with. For the real HHI thresholds, one has to refer to
6 the FTC enforcement statistics. For future competition, see
7 the 1984 Guidelines. And for everything else, go to the
8 2006 commentary.

9 Ideally in this round of revisions, we should take
10 a comprehensive, back-to-basics approach. In the process of
11 that harmonization, I would also urge that the Agencies give
12 due consideration to the principle of certainty. To the
13 extent that we end up with some clear guidance about what
14 kinds of transactions will not give rise to an
15 investigation, that is probably in some respects more
16 valuable than certain knowledge about what will.

17 So a couple of specific suggestions. First,
18 overall reliance on pure market share analysis is misplaced.
19 Market share is often a poor proxy for market power,
20 particularly in rapidly evolving markets. A particularly
21 good case in point would be the Apple iPhone. First
22 introduced in 2007, the rate at which the iPhone has
23 captured share among smartphones has been extremely rapid.
24 Indeed, statistically, given that this device in effect
25 created the category, the iPhone's growth has been

1 phenomenal. However, it takes only the most cursory glance
2 at the cellphone market to recognize that by no definition
3 could Apple be said to possess market power with respect to
4 cellphones or even smartphones.

5 We've seen at least four very credible new
6 entrants in just the last three months: Palm, Motorola,
7 Dell, and Google, with additional players, in particular,
8 Microsoft rumored to be preparing to enter the field.

9 Second, in lieu of a price-based analysis let me
10 suggest that a product-based analysis may be more probative
11 in dynamic markets. So, for example, are the products of
12 the merging firms similar or differentiated. Are there
13 other products in the relevant market that are similar on a
14 feature-set basis or are they highly differentiated? Is
15 there an emergent product which is rapidly gaining share or
16 is likely to disrupt the market? What are the respective
17 gross margins of the merging entities' products?

18 This is the kind of approach that I think we saw
19 from Vaughn Walker in the *Oracle-PeopleSoft* opinion, and I
20 think it makes sense in the context of these kind of fast,
21 evolving companies.

22 Another key factor to consider would be to apply
23 the analysis respective to intellectual property positions
24 of the merging entities. Will the combination produce a
25 patent bottleneck that could slow down or dissuade new

1 entrants from approaching the market?

2 Finally, a plea for more explicit guidance
3 regarding future competition. The standard for
4 consideration of future competition is unclear at best. Is
5 it clear proof or reasonable probability. Entities
6 operating in a dynamic market often see competitors long
7 before empirical evidence of actual competition exists.
8 This is a key issue for serial innovators such as Apple.
9 Companies that innovate aggressively and move into new
10 markets tend to be ahead of the competition for at least a
11 while, but the famous quote by Andy Grove that only the
12 paranoid survive is really a reflection of the fact that we
13 consider many companies, both in direct and adjacent
14 markets, to be future competitors.

15 Sometimes it's not even the new companies but new
16 technologies entirely that will be the most disruptive. The
17 Guidelines should be very flexible and set a relatively low
18 bar in terms of evidence required when accounting for the
19 potentiality of future competitors in markets that have a
20 history of rapid change.

21 These are just a few suggestions. I hope they've
22 been useful. And I again thank you for giving me the
23 opportunity.

24 PROFESSOR SHAPIRO: Thank you, Bruce.

25 David.

1 PROFESSOR TEECE: Thank you, Carl. First of all,
2 Carl, thank you for the introduction you gave to this
3 session which both delighted me but also surprised me.

4 It delighted me inasmuch as you pointed out, it's
5 glaring, the absence of a treatment of innovation from the
6 Guidelines is glaring. But you also surprised me by saying,
7 notwithstanding that, that in the Agencies there's
8 widespread recognition that innovation is king. I don't
9 believe that's the case.

10 I think if there was widespread recognition that
11 innovation is king, the way the Agencies go about their
12 business and the kinds of tools that are used to analyze
13 Section 2 as well as merger cases would be quite different.

14 I nevertheless recognize that considerable
15 progress has been made, some of you that know me know that
16 I've been beating on this drum for about 20 years, and to
17 find fellow travelers who now say that putting forward the
18 innovation story is a strawman because we've got that part,
19 and in fact we're busy at thoroughly analyzing how
20 innovation drives competition and how competition drives
21 innovation, I'm very pleased to learn that this may be the
22 case.

23 Although, Carl, I suspect it's true with you and
24 some of the people that you brought to this session, but I
25 don't think it represents where the Agencies are and it's

1 not where the economics profession is, so I think there's
2 work to be done. There's great opportunity to start that
3 work as we think about revising the Guidelines.

4 To back up a little bit, it's not a new idea. I
5 mean what we've heard from the industry representatives is
6 of course perfectly true and we know it's true. We know,
7 all of us in this room know that innovation drives
8 competition. I mean this is what Schumpeter told us: The
9 kind of competition, this kind of competition, he's
10 referring to innovation-driven competition, is as much more
11 effective than the other as bombardment is in comparison
12 with forcing a door and so much more important.

13 If you go back to Judge Learned Hand, he says
14 consumer interests in the long run are quite different from
15 an immediate fall in prices. Yet what the Agencies seem to
16 focus on is an immediate fall in prices. This is how we've
17 come to think about consumer harm. Or an immediate rise in
18 prices is how we come to think about consumer harm and
19 consumer benefit.

20 If you take innovation as being king, and Carl and
21 I agree that it is, then I think you have to take a somewhat
22 different perspective, and maybe it's a little bit more of a
23 long-run perspective. I think that the time how now come,
24 since the basic point everybody is in agreement with is to
25 say: All right, if in fact innovation is king, what does it

1 mean in terms of the way we go about doing antitrust
2 analysis?

3 I think we've only just started down that road.
4 By the time we're finished, it'll be a long time before
5 we're finished, I think that antitrust will look different
6 from the way it does today.

7 In my view, what we've done in competition policy
8 is that we've essentially accepted static competition over
9 dynamic competition. That almost everything the Agencies do
10 favors static competition and not dynamic competition. And,
11 as I said before, it's not just in merger policy, it's in
12 Section 2 analysis.

13 Why is it, you might ask, since everybody in the
14 Agencies is a champion of competition, why would they accept
15 the weaker brew? Why have the Agencies and so many of our
16 economists accepted the weaker brew, which is static
17 competition, focusing on short-term price effects rather
18 than thinking about the fundamental question which is:
19 What's the impact on innovation and, the other side of the
20 equation, how does innovation drive competition?

21 I think the fundamental reason is because we lack
22 and we haven't bothered to focus on developing the
23 analytical tools. So we live with a set of tools which are
24 within our comfort zone and which we can manipulate and
25 pretend to be objective and transparent with, but in fact

1 those tools continue to degrade the policy, the use of those
2 tools, the widespread use of those tools, it sometimes
3 degrades the quality of our antitrust work.

4 I'm not thinking about a whole bunch of, at least
5 for me, uninteresting industries where I think the standard
6 static analysis works. If you're analyzing supermarkets and
7 goodness knows what else, where there's not much innovation,
8 I think the standard approaches work. But when you're
9 looking at the most interesting portions of the American
10 economy, those standard approaches simply don't work. The
11 apparatus that we bring to bear is not applicable.

12 This is true whether you're talking about the
13 tools of the Chicago School or the post-Chicago tradition.
14 Unfortunately, almost always those tools assume an
15 unchanging technology and they assume a fixed set of
16 products. So whether you're using a Chicago approach or a
17 post-Chicago approach, what's missing fundamentally behind
18 it all is a robust theory of the firm. By "the firm," I
19 mean the kind of firms that are represented here at this
20 table.

21 The models that we economists use are poor
22 caricatures. They are simplifications, and of course
23 simplification is necessary. But it's not just that they're
24 simplifications, they're caricatures; and so they tend to
25 mislead and tend to cause us to focus on the wrong thing.

1 The basic reason I think why we don't have more
2 adroit antitrust policy that drives what Carl recognizes as
3 -- which supports or favors or gives primacy to innovation,
4 the reason we don't have it is the analytical frameworks.
5 Of course, the Guidelines are about analytical framework, so
6 there's a wonderful opportunity here to get it right.

7 Now, I think one of the very first and most
8 primitive propositions that has to be understood is that
9 innovation drives competition. I actually spent a little
10 time reading through the various materials of the Agency to
11 see if I could find that proposition. I couldn't. You can
12 find multiple references to the fact that competition can
13 stimulate innovation. And indeed it does. And quoting from
14 the FTC 2003, "Competition can stimulate innovation.
15 Competition amongst firms can spur the invention of new or
16 better products and more efficient process," which is one
17 side of the equation. The other side of the equation, which
18 said innovation can drive competition, is missing.

19 The evidence, of course, that links concentration
20 to innovation, notwithstanding the frequent reference to it,
21 is weak. And we know why. It's in part because we don't
22 quite know how to define markets correctly, but it's also
23 because there's a lot of other intervening factors. Market
24 concentration is only one of many, many factors that affects
25 the rate and direction of innovation at the enterprise

1 level, but it's the only factor that is looked at in most
2 antitrust analysis.

3 If I go back to how do we move towards a better
4 understanding of dynamic competition, in terms of what's
5 needed, I think it is new conceptual frameworks. Let me
6 just rattle off a bunch of concepts; maybe Carl and Joe will
7 tell me that everybody at the Agencies is deeply familiar
8 with all of these and applying them as appropriate, and I
9 know some of them are talked about.

10 One is the concept of the appropriability regimes.
11 I'm going to rattle off a series of concepts that are well
12 developed outside of mainstream economics. There's a big
13 literature in innovation studies that some of you in this
14 room are familiar with. There's a big literature in
15 strategic management. People who do study innovation have a
16 pretty good understanding of the way that innovation works
17 and the types of organizational structures and competitive
18 arrangements that stimulate innovation and vice-versa.

19 When I say a pretty good understanding: A much
20 better understanding than you would think based on the kinds
21 of language that you get in the various Agency reports. But
22 that stuff is not being ported over into economics, and it's
23 because there is this difficulty with the basic sort of
24 economic paradigm for neoclassical economics which relies on
25 equilibrium analysis and the assumption that you can

1 characterize a firm by a simple production function and the
2 marginal-cost curves and so forth. That implicit theory of
3 the firm is being displaced outside of economics, but
4 economics as a discipline is not talking to the field of
5 strategic management and vice-versa, with the exception of
6 certain small domains that I can come back to later.

7 The concept of the appropriability regime, the
8 manner in which firms are able to capture returns from
9 innovation. The concept of technological opportunity.
10 Actually if you go back to Scherer's textbook, he used to
11 talk about technological opportunity and how that affected
12 competition. That seems to have been dropped in the last 20
13 years from at least most of the stuff that I've read from
14 the Agencies.

15 In areas where there's rich technological
16 opportunity, then in fact the kind of surprises in being
17 "only the paranoid survive" is true in those types of
18 environments. But are the Agencies trying to map
19 technological opportunities as an environmental variable?
20 No, they're not.

21 The concept of a technological paradigm, the way
22 there are some regularities in the way technologies evolve.
23 I think there's some understanding of that but little talk
24 about it.

25 Certainly the cumulative nature of innovation,

1 various types of innovation they discuss. The notion of
2 competence and the fact that you can have, I think,
3 competency enhancing innovation and competency destroying
4 innovation, I think there certainly is a notion of
5 disruptive innovation. In fact, you heard Carl mention that
6 earlier, but there is a very rich literature outside of
7 economics which I believe is highly relevant. Now it's very
8 untidy, but just because it's untidy and will therefore make
9 the lives of the staff at the Agencies very uncomfortable,
10 and it's going to take everyone out of their comfort zone to
11 go into this is not a reason not to do it. And yet I
12 believe that is the reason why it is not embraced. It's not
13 embraced because it complicates life, and a lot of the
14 shibboleths that we like to hold onto in antitrust are going
15 to get challenged if you take this literature seriously.

16 So it's going to take a lot of work, but the good
17 news is that there is more than an emerging literature,
18 there's a wide body of research, it's not bad, that I think
19 can usefully inform antitrust analysis.

20 And there's been almost no work done to port that
21 over. I know because when I read that literature and I read
22 the antitrust literature and I think about the crossover
23 articles, they're almost not existent at all.

24 PROFESSOR SHAPIRO: Well, then let me ask you
25 then, David. So we've heard from the industry

1 representatives' --

2 PROFESSOR TEECE: Yes.

3 PROFESSOR SHAPIRO: -- desire for predictability
4 and some certainty and speed in review. I think there's a
5 consensus that the primary function -- I don't want to
6 overstate this -- but the Guidelines in large part should
7 provide a framework for how the Agencies will analyze
8 things.

9 I think we very much, because we're trying to
10 predict things, particularly in uncertain markets, we tend
11 to focus a lot on the incentives of the firms and how the
12 merger will change incentives, which we think we can
13 understand.

14 You suggested that we should then, I think I'm
15 hearing you say there are certain analytic tools that are
16 not being used because they're disfavored and not
17 appreciated.

18 PROFESSOR TEECE: Right.

19 PROFESSOR SHAPIRO: So could you -- and I'm trying
20 to come to the very practical perspective --

21 PROFESSOR TEECE: I know you are.

22 PROFESSOR SHAPIRO: -- of if we, the Agencies are
23 going to put in material to describe how we analyze
24 innovation in some of these dynamic markets, and we can talk
25 about how we'll change Section 1.251 and market shares, that

1 we can talk about, that's a good thing, --

2 PROFESSOR TEECE: Right.

3 PROFESSOR SHAPIRO: -- I've heard a call for that,
4 can you point to specific analytic tools that you think
5 should be included in the Guidelines with the other
6 admonition, a number of people have said we don't want to
7 throw stuff in there that hasn't been tested that's
8 experimental -- I think, Mark, you said something along
9 those lines.

10 So if you could wrap up by indicating --

11 PROFESSOR TEECE: Yeah.

12 PROFESSOR SHAPIRO: -- a tool or two, a specific
13 thing that your broader perspective would bring, that would
14 be helpful.

15 PROFESSOR TEECE: Absolutely.

16 COMMISSIONER ROSCH: I'll throw out one other
17 challenge. That is all of the speakers and yourself
18 included talk about the virtues of innovation on a
19 long-term --

20 PROFESSOR TEECE: Right.

21 COMMISSIONER ROSCH: There's no question that in
22 some markets, we're not talking about yours specifically,
23 Mark, or yours, Greg, or yours, but in some markets, the
24 multi-sided markets, they create barriers to entry, and so
25 they are long-term drivers of innovation. There's no

1 question about that.

2 So what do we mean by long term? What do you mean
3 by long term? How long do you think the Agencies should
4 wait for these markets to correct themselves? How --

5 PROFESSOR SHAPIRO: Okay. We have multiple
6 questions on the floor.

7 PROFESSOR TEECE: Okay. Well, let me make a more
8 general statement first, which is the burden should not be
9 on me. I've been beating this drum for 20 years and now you
10 say, gee, but if you can't lay out the fully panoply of what
11 we need to do, we're going to continue on doing what we did
12 before even though we know it's wrong.

13 PROFESSOR SHAPIRO: All right. David, if you --
14 the Guidelines are not about imposing burdens.

15 PROFESSOR TEECE: No, no, no.

16 PROFESSOR SHAPIRO: Or presumptions. So if you
17 care to suggest --

18 PROFESSOR TEECE: Let me drop several practical
19 things --

20 PROFESSOR SHAPIRO: -- then that would be helpful.

21 PROFESSOR TEECE: You know given that there's a
22 lot of arbitrariness in the Guidelines already, timing of
23 entry and so forth, an arbitrary timeframe is the length of
24 the product lifecycle. You know the long term is something
25 beyond the length of the product lifecycle and the short

1 term may be something inside of it.

2 There's a whole bunch of points that I make in my
3 outline here and Greg Sidak and I have a paper which is in
4 the *Journal of Competition Law and Economics*, which tries to
5 go into some of these issues. I think you end up, first of
6 all, not being enthusiastic about market definition, at
7 least the way that it's done, focusing not on the products
8 per se but on the capabilities of firms.

9 A more confident way to think about the strength
10 of competitors and so forth is to look at their capabilities
11 rather than to look at where they are in the market. The
12 market is a current snapshot and an expression of their
13 capabilities in terms of the set of products they're
14 currently doing, but you have to back up in a Penrosian
15 sense to the firm's basic resources and asset base. So you
16 have to do more analysis of the firms themselves rather than
17 of what's going on in the market.

18 Look, there are not clear answers to a lot of
19 these, but that's not the reason. We shouldn't be looking
20 under the light, the old story of the professor that lost
21 his keys looking in the lamppost because that's where the
22 light is better. There's a lot of that going on. And I
23 think we're focusing our efforts the wrong way.

24 We've got to break out and start to follow the
25 natural implications of what Carl has just said.

1 PROFESSOR SHAPIRO: Okay. I think --

2 PROFESSOR TEECE: I know I'm out of time. There's
3 ten points around revisions that are in the last of my
4 slides, and I'm sure we can come back to them in the
5 discussion.

6 PROFESSOR SHAPIRO: Thank you, David.

7 Tim.

8 PROFESSOR BRESNAHAN: Well, like David, I study
9 competition and innovation for a living. But unlike him, I
10 think I'm going to be Dr. Incremental to his Dr. Millennium
11 in terms of change.

12 Largely here I'm responding to the worry I heard
13 from my industry colleagues, which I have not heard this
14 time for the first time this afternoon, that particularly in
15 technology-intensive industries, because of the way they are
16 written, the Merger Guidelines and other policy documents
17 are hard to decode.

18 Where if you're in a mature consumer-products
19 industry and you have antitrust counsel who has been working
20 on mature consumer-products industry cases for many years
21 before the Agencies, you can get a lot of predictability
22 about what's going to happen to your deal in timing as well
23 as in outcome, that's much harder in industries where things
24 change more rapidly.

25 However, if we look at the broad spectrum of this,

1 the revision to the Guidelines has to pick up not only the
2 extremely dynamically-competitive industries which are my
3 neighbors here in Silicon Valley, but it needs to pick up
4 the broad brush of industries. In the broad brush of
5 industries, I would say, there are some findings from the
6 systematic study of competition and innovation which matter.

7 The first one which comes out of exactly the kind
8 of literature that David was talking about is most of R & D
9 is D. There's not a lot of R out there. In most
10 industries, most of the time, the players a couple of years
11 from now and the players today are going to be the same
12 players. So we should not necessarily worry in a lot of
13 industries if -- to follow Gilbert and Sunshine, for
14 example, and think about using R & D data to define dynamic
15 markets. I mean it's got a long series of problems in most
16 industries. You can't figure out what the R & D is brought
17 out. You know products, you know who bought them. R & D,
18 you don't know easily from the outside quickly to give
19 people in merging companies some certainty that they know
20 how their deal's going to be looked at. You don't know
21 where R & D is going. So I would be against something that
22 has sort of a quantitative flavor that's more forward
23 looking along the lines of Rich Gilbert.

24 The other thing I'd say is that we shouldn't
25 forget that just as innovation is very important for

1 competition, competition is very important for innovation.
2 I think the most important part of the stories we heard from
3 the three industry representatives this afternoon is how
4 important dynamic competition has been.

5 So I would argue for a more careful statement
6 about what kinds of factual evidence can be brought to bear
7 by either side, either side, in an antitrust case that
8 current market shares aren't the thing you want to look at.

9 So the first one, let me take the prosecutors
10 first, because I think that's maybe easier. Carl suggested
11 the idea of a merger with a disruptive entrant. I think
12 everyone would have to agree that a merger with -- if we
13 could follow David Teece the full way, the disruptive
14 entrant is the only one that has the relevant capabilities
15 to come in and compete. And a merger with a -- well, I
16 would want to put a fairly high factual proof threshold
17 along the lines of those FDA records. I find the FDA
18 records reasonably attractive. On the other hand, --

19 PROFESSOR SHAPIRO: You do need proof that there's
20 not three other guys who are also doing the same thing.

21 PROFESSOR BRESNAHAN: And proof that there's some
22 reasonable proposition that it's actually disruptive and
23 it's going to work out, because in many, many contexts,
24 you're forcing on a disruptive entrant. If you require them
25 to enter and build up.

1 Take the industries where you need not only purely
2 technical capabilities but you also need widespread
3 distribution capabilities. Here is an example where I would
4 say the efficiencies from a merger can be in the foreground.
5 Every time there's a press release somewhere that says that
6 this is a disruptive technology, you don't want that to be
7 the factual foundation. I mean there have been 75 of those
8 press releases issued within five miles of here since we
9 started this particular session. They are going to change
10 the world, and more power to them.

11 So similarly on the defense side, I like Mark
12 Chandler's articulation a lot. His is an industry where
13 there is a proven track record in historical data, not
14 necessarily market-share data, that there's been a lot of
15 change in entry and that his company has been very effective
16 at bringing into connection with its established assets,
17 particularly connection to customers new technologies. So I
18 would say that you could really put a factual foundation on
19 that.

20 I would say the same thing on convergence. You
21 might think and, again, I want to be symmetric, just because
22 we're thinking about Guidelines here and you want to think
23 about being on both sides of the same fact issue, whichever
24 side of the case you're on.

25 The Agencies might be tempted to say about

1 convergence: Looks like these two areas which used to be
2 really separate are converging and these are the two
3 companies that can do it, and so we're not going to let them
4 merge even though the merger today looks vertical or end to
5 end.

6 I'd want to put a fairly high factual foundation
7 under all of the elements of that. The convergence is
8 really going to happen. The convergence between the
9 computer business of Northern California and the
10 entertainment business of Southern California was predicted
11 pretty much every year before the iTunes store opened.

12 So, again, you got to be careful when you're
13 thinking about things that you can put in Guidelines and I
14 would say we will look at real evidence that things are
15 about to change on the entry side or on the convergence
16 side, both in forming our theory of why that might be a harm
17 to competition and especially in forming our theory of why
18 there might be no harm to competition from these two
19 particular parties.

20 I think expanding what kinds of factual bases,
21 historical track and industry level of change that is going
22 to be one; historical company behavior and reputation I
23 think that's going to be another. Those are going to be
24 very helpful.

25 I think incentives changes for R & D is another

1 area where much good could be done. Mark in particular and
2 to some extent Greg talked about the efficiencies that can
3 be achieved by getting rid of duplicative R & D efforts.

4 And I think they're right. In industries where
5 there's a high ratio of fixed-to-variable cost, which is not
6 all dynamic industries, that's a cognizable, competitive
7 effect. The tricky bit there, I think, is telling the
8 difference from the outside between the duplicative
9 innovation efforts, where you'd really like to get one of
10 them shut down, and the antiduplicative innovation efforts
11 that go with, for example, the story of the disruptive
12 entrant. So there's some tension between trying to argue
13 both of those points at once.

14 Here I think my advice to the Agencies would
15 probably be: Don't try and do too much, because if you try
16 and get in the game of figuring out when the entrant really
17 has a different idea versus when it's duplicative, certainly
18 at an early-screen stage that's going to be helpless and
19 that may be helpless even in the end game.

20 And, noting my lateness, as past me, the time's
21 up, I think, with particular force.

22 PROFESSOR SHAPIRO: Thank you, Tim.

23 I have to say in having worked with a lot of the
24 companies, a number of companies out here, and also been in
25 Government, a number of these comments really -- I often say

1 this to friends who don't do antitrust, the companies here
2 in Silicon Valley and other innovative companies, they say,
3 'My market's so dynamic, I'm looking over my shoulder. I
4 can't sleep at night. And then I go into the Government and
5 they think I can just rest on my laurels or raise the price.
6 They don't get it.'

7 And so those are sort of the culture differences
8 across from coast to coast, if you will. We're trying to
9 get it as best we can.

10 Let me be very focused here because we have not
11 that much time left and there's a lot of stuff on the table
12 here that's really interesting actually to me and I suspect
13 to others. Let me focus on two areas -- first this
14 particular section actually that I think Mark mentioned, can
15 we measure, adjust market shares so that we look -- we're
16 still going to use markets and market shares. So how do we
17 do that in a dynamic setting? That's one thing.

18 And the other thing is efficiencies and R & D, and
19 I get to that, too.

20 But the first one, so I guess it seems to me that
21 the Guidelines could be updated to say: Look, we can look
22 at historical market shares, but we can do more. We can
23 look at trends in those. We can try to factor in new
24 companies that are coming in or companies whose products are
25 ending their lifecycle, to come up with a projected market

1 share a year or two out.

2 This is still, I understand, it's market share,
3 it's based on markets. There are all sorts of criticism.
4 We could say about how we do that a little bit. I sense,
5 Greg, that you would welcome that, and I don't think this
6 would be creating something that's totally alien or unknown.
7 I mean we do this actually already to some degree.

8 Would that be welcome? Are there pitfalls?

9 Short responses for people who want to speak to
10 that.

11 MR. SIVINSKI: I'll start out and say, yes, I
12 think that's actually the kind of guidance that could be
13 most useful. I think part of the frustration you hear from
14 companies generally is that Guidelines are silent on these
15 issues and we don't feel like we're having a conversation
16 with the Agencies about it.

17 Something that said we're going to have that
18 conversation, that the standard of proof applied will be
19 uniform as between looking at anticompetitive effects versus
20 procompetitive efficiencies. Those kinds of basic
21 procedural clarifications I think would be very useful.

22 PROFESSOR SHAPIRO: And let me actually amend this
23 while still getting more responses. One could also imagine
24 saying if market shares have been quite variable and not
25 stable, then we would tend to give concentration less weight

1 because it's not as good a prediction of the future.

2 MR. SEWELL: Yes. Let me just quickly, I think
3 picking up on Commissioner Rosch's idea, there is a temporal
4 notion here that is very, very important. And so to look at
5 the market share as a static element is, I think, missing a
6 lot of the dynamic aspects of the industry.

7 When you have very rapid gain in share, when you
8 have volatility in share amongst the various players, all of
9 those are factors that I think should sort of indicate to
10 the Agency that this is perhaps a more dynamic, a more
11 volatile market. Whereas if you have persistent high shares
12 and very little turnover amongst the companies responsible
13 for that share, then it sends a different message.

14 PROFESSOR SHAPIRO: And this is in principle
15 neutral in the sense you have a company with a small share
16 up and coming that could cause more of a concern.

17 MR. SEWELL: Absolutely.

18 PROFESSOR SHAPIRO: But in another case it could
19 go the other way.

20 Tim, you were nodding, did you want to or...

21 PROFESSOR BRESNAHAN: I just want to say yes.

22 MR. CHANDLER: I would say, Carl, it wasn't I, by
23 the way, who said don't put untested variables in. I think
24 my point is more there are going to be some factors that are
25 going to be more qualitative in nature and I think David's

1 quip about the professor looking where the light is the
2 tyranny of hard variables. You can measure an HHI.

3 I was struck by the comments from some of the
4 previous workshops from people who decried the rigidity of
5 HHI because it wasn't really applicable in a lot of cases,
6 and then they started looking at what the alternatives were
7 and they said, 'Well, at least we understand that, so please
8 don't touch it.' And I think there's that danger.

9 So I can say some of these are qualitative and
10 will require hard work of analysis in saying maybe we don't
11 have great proxy variables for them, but they're the real
12 world. So you go talk to customers. You look at what's
13 going on in the industry. You look at where the venture
14 money is going and how much money is being put into new
15 potential entrants there, to say how dynamic is this market,
16 how different is it going to be tomorrow.

17 And recognize that the players who are in the
18 position of making acquisitions at that time are equally
19 affected by what's going on in the venture world, whether
20 they think that market is going, and that's a huge factor in
21 their motivations.

22 Now motivations may be nice. I know you're
23 worried about the fact: Is price going to be increased
24 afterwards.

25 PROFESSOR SHAPIRO: Well, let me push you a little

1 bit to see where that goes, Mark.

2 I think -- and this is meant to be a template of
3 the type of puzzle that we face a lot which is you mentioned
4 the venture capitalist. Suppose we got a situation where
5 the two merging companies are important current competitors,
6 as measured by shares, as measured by the perception of each
7 other, whatever evidence you want to talk about. But there
8 is a lot of people trying to get in. There's venture
9 capitalists, there are start-ups that are trying. It looks
10 like a growing area. There's technological opportunity, to
11 bring in the important term David mentioned.

12 The Agencies tend to say, well, look, we don't
13 really know what's going to come of that stuff. We see you
14 guys are in there and now competing, so we're going to give
15 a little weight to that.

16 Well, as in the Valley people say, 'We better not
17 rest on our laurels. All these guys are coming out to get
18 us.' There is a tendency to discount some of the future
19 stuff when it seems uncertain or speculative. In the
20 antitrust analysis can we -- should we change that?

21 MR. CHANDLER: Well, let me respond to that.

22 PROFESSOR SHAPIRO: And then David afterwards. I
23 know you've been trying to get in?

24 MR. CHANDLER: And I'll stop. Here's the problem,
25 very few of our acquisitions are horizontal. I mean

1 generally we're looking at adjacent markets, and that's the
2 case.

3 COMMISSIONER ROSCH: You're at the wrong workshops
4 then, but okay.

5 MR. CHANDLER: That's another question, but that's
6 okay. But there are cases where they are. And what's
7 interesting to me is that the Agency's analysis focuses on a
8 horizontal piece, whereas what we may be interested in the
9 acquisition has nothing to do with the area of product
10 overlap, but with some other technology that's there.

11 PROFESSOR SHAPIRO: Or capabilities that you're
12 getting, I imagine?

13 MR. CHANDLER: It is, or capability that's going
14 to be relevant going forward in what's a very different
15 marketplace. This is a little sensitive at the moment, but
16 if Skype and LG and Panasonic are going to try to bring
17 Skype-like video to high-definition television sets in
18 people's living rooms, then you question why would people
19 who are both active in high-definition telepresence try and
20 merge? Are they trying to make themselves bigger or is
21 there some other technology there that's going to be
22 relevant to a video world that's going to look totally
23 different in a few years? And you have to then be in the
24 business of assessing, well, is it really going to look
25 totally different in a few years.

1 PROFESSOR SHAPIRO: And we try to, in that sort of
2 situation, try to arrange a fix that will solve our concern
3 and still let you guys go forward with a lot of those
4 nonhorizontal issues.

5 David, I know you've been trying to get in.

6 PROFESSOR TEECE: You have to think that the
7 enterprise that you're in is really extraordinarily
8 ambitious because you're trying to create some guidelines
9 that work across the entire economy, from potato chips to
10 silicon chips.

11 I know there's anathema to drawing sort of
12 industry lines, and I don't think you should. But I wonder
13 whether or not you can't draw lines around the types of
14 competitive regimes. Find a clever way to do it that sort
15 of characterized these highly dynamic industries. And then
16 the kind of tools that you use for supermarkets where they
17 work just fine. No one should wheel them out if you're
18 talking about semiconductors or biotech, or what-have-you,
19 and that you get a more granular understanding of where the
20 tools work and where they don't work.

21 And one aspect of these markets where dynamic
22 competition rules, in my view, is that potential competition
23 is more important than actual competition. I mean
24 indirectly all the antitrust analysis that we use in mature
25 industries, it's focused on actual competition, and so the

1 potential competition is a bit of an after thought.

2 But if you actually look at the biggest drivers of
3 competition, it comes from the new entrants, and innovation
4 that upsets the existing order and, in effect, moves
5 innovation across all sectors of the economy comes from the
6 outside.

7 So I think in these different environments it also
8 elevates the importance of potential competition, which
9 affects merger analysis both ways. It means that some will
10 get through and that maybe wouldn't get through now and it
11 may mean that some that get through now wouldn't get through
12 in the future.

13 But there's sort of explicit recognition of the
14 different role of potential competition in these
15 environments, where, as Andy Grove said, "Only the paranoid
16 survive," because, in fact, it is fear of not just the
17 identified potential competitor but the unidentified
18 potential competitor that's driving daily decisions.

19 PROFESSOR SHAPIRO: I guess, you know, one of the
20 questions: How far do we go to try acknowledge and
21 recognize these --

22 PROFESSOR TEECE: Yes.

23 PROFESSOR SHAPIRO: -- potential competitive
24 things that may be hard to discern or identify? I mean you
25 go pretty far in your submission, saying where innovation

1 activity is high, one should presume it and monopoly power
2 does not exist. And I don't think we would want to go
3 nearly that far if the combined shares were very high, but
4 at the same time want to acknowledge these forces of
5 potential competition. And that is a puzzle.

6 I think we totally take onboard that since we do
7 have to apply to all the industries, we --

8 PROFESSOR TEECE: It's tough.

9 PROFESSOR SHAPIRO: It's tough. But that's why I
10 want to focus on that section, about changing market shares,
11 okay, which may not apply to the supermarkets -- or it could
12 in a way. But it could be flexibly described where they are
13 changing.

14 The other section I think -- so the other thing,
15 to fill the gap, if you will, of saying so little in the
16 Guidelines about innovation is to have a separate section or
17 subsection, whatever, paragraph of some sort, that talk
18 about effects on innovation of a merger and innovation
19 incentives.

20 And this, I think, because I want to ask what you
21 all think might go in there and kind of maybe lead the
22 witnesses a little bit, at the same time bringing in the
23 points about efficiencies. Okay. So one of the things I
24 think has happened is because the Guidelines focus so much
25 on short-term pricing competition, they naturally focus on

1 marginal cost, which does affect directly the incentives for
2 prices.

3 However, if you start to talk about R & D, product
4 introduction, product quality improvements, those are things
5 in which some of these costs that are fixed for the purposes
6 of the pricing analysis are no longer fixed. It's how much
7 do you have to spend to introduce that new product.

8 So if we think about another dimension of
9 competition, innovation, let's call it broadly, we naturally
10 would credit efficiencies if they were merger-specific and
11 otherwise. They wouldn't be fixed, they would be variable
12 with respect to the decision at hand, namely, improving
13 products. We could then try to analyze how will the merger
14 affect the incentives of the merging firms to introduce new
15 products.

16 We could see the natural thing, from my
17 perspective at least is then to say: Well, maybe you save a
18 bunch of money on -- I won't even call them fixed costs --
19 R & D costs, let's call them because they're not fixed now.
20 And yet there's some potentially reduced incentives if you
21 are going to go after each other's products that you would
22 have cannibalization. So there would be basically a
23 diversion that would be internalized, you might have fewer
24 incentives to innovate. And then you've got the
25 appropriability issues as well. You might have a greater

1 appropriability.

2 So by talking about efficiencies, cannibalization,
3 and appropriability, one could imagine telling a story that
4 would be general but helpful regarding innovation effects.
5 It would apply to some industries, not others. We wouldn't
6 say which industries. I'm curious about reactions to that.

7 David, first finger up in the wind.

8 PROFESSOR TEECE: The spirit of the question is
9 precisely on point, but I think you have to broaden it to
10 beyond sort of efficiencies, because efficiencies is almost
11 sort of a static concept. I know you mean dynamic
12 efficiency, but it's a lot of the mergers and asset
13 acquisitions are done for reasons that are not thought of by
14 management as efficiencies but as effectiveness for
15 appropriability, for complementarities, and what-have-you.
16 So I think you have to kind of find a new vocabulary to sort
17 of getting the socially desirable -- you want the most
18 socially-desirable arrangements, and I'm not sure that
19 people's notions of efficiency necessarily capture that.

20 PROFESSOR SHAPIRO: Well, in merger law I would
21 say efficiencies are a pretty well established term. So
22 rather than change that term, if one is going to do
23 something, you might explain what would count as a merger-
24 specific efficiency in this context.

25 PROFESSOR TEECE: Okay.

1 PROFESSOR SHAPIRO: So I think that if you take as
2 a friendly amendment.

3 PROFESSOR TEECE: Fair enough.

4 PROFESSOR SHAPIRO: Tim.

5 PROFESSOR BRESNAHAN: Carl, I like your
6 articulation a lot, but let me rephrase it slightly.
7 Suppose you were to take seriously the suggestion that there
8 are industries in which looking at price effects is not the
9 first order competition problem. Then so you might say
10 we're thinking about market shares one product cycle from
11 now. We're thinking about the costs of introducing better
12 products one product cycle from now. We're thinking about
13 the futures of those products rather than really about their
14 prices.

15 And we're thinking about what firms today, because
16 we have to make our decision today, what firms are in a
17 position in terms of their incentives and capabilities to be
18 bringing those new production features in. And would this
19 merger seem to change, for the worse, the competitive
20 incentives, to bring out the features customers really want.

21 I mean that seems like that really wasn't about
22 efficiencies, but it was I think the same thing you said.
23 That seems like an inquiry that, particularly if there were
24 documents from the merging firms in hand, and lots of the
25 relevant industries would actually be an answerable inquiry.

1 MR. SIVINSKI: I'd like just to agree with that
2 for the simple reason that I don't think we've really
3 addressed Commissioner Rosch's question about mavericks and
4 tipping markets. And I don't want to leave the impression
5 at least Microsoft as sitting up here saying all our deals
6 should be left alone because they're innovative. I think
7 there needs to be some way of looking at these things, and
8 actually that strikes me as a quite sensible way of looking
9 at it.

10 PROFESSOR SHAPIRO: I'm thinking this would be
11 actually very parallel at least to an economist's way of
12 thinking to what we do on pricing, we're just doing a
13 similar analysis for innovation or product improvement.
14 There are different variables. Some costs are fixed
15 variable, and so forth.

16 MR. CHANDLER: To also bring customer power into
17 this as well in the sense that, especially thinking about
18 diversion ratios, that the markets aren't entirely distinct
19 between present-generation products and future-generation
20 products. And so there are going to be situations where
21 customers will be able to use the prospect of competition in
22 the next-generation market to constrain any efforts to raise
23 prices with the present production generation. That's
24 another factor I think needs to be taken into account.

25 PROFESSOR SHAPIRO: I like that as well.

1 The other thing I should actually respond to what
2 David said, one could imagine saying, well, look, we've
3 looked at this dimension, product-improvement innovation,
4 and we see some creditable efficiencies. And, yes, maybe
5 there are some adverse effects on price. You could imagine
6 weighing them. It's very hard. Or at least in principle
7 saying, you know, there's enough good stuff here for the
8 longer term, that I'll tolerate something.

9 Now, you don't want to have consumer harm in the
10 short term for totally illusory benefits, and that's an
11 issue. Okay, how likely are these things to happen, and I
12 doubt we would address that except to note that longer-term
13 benefits should be much more than speculative in order to be
14 credited.

15 Let me open it up. Tom, I know you --

16 COMMISSIONER ROSCH: It's not anything new.

17 PROFESSOR SHAPIRO: All the better.

18 COMMISSIONER ROSCH: The General Dynamics --

19 PROFESSOR SHAPIRO: Right.

20 COMMISSIONER ROSCH: -- of the analysis, for
21 example, --

22 THE REPORTER: (Raises hand to indicate the need
23 for the microphone.)

24 PROFESSOR SHAPIRO: You need to turn that on. I
25 think we've told you they have to turn that on.

1 COMMISSIONER ROSCH: Yes. And in some instances
2 current market share is not a good predictor of future
3 market shares. So the notion of looking at trends; the
4 notion of looking at where the venture capital dollars are
5 going; the notion of looking at, in general, that factors
6 that point us to whether or not the past is prologue, it's
7 not anything brand new. It's something that we are familiar
8 with and we should use and they should be in the Guidelines.
9 I'm completely in agreement with all of you gentlemen on
10 that score.

11 I think where I depart, at least maybe, is that I
12 tend to think take key question is indeed, Mark and Greg and
13 Bruce, it's the time horizon. It is temporal.

14 I disagree with you, David, that the reason the
15 Agencies don't look at dynamic efficiencies is because we
16 just don't have the tools. The reason I think that the
17 Agencies don't pay as much attention to that is because it
18 is very long term in many instances. It is very long term.
19 And there is a real possibility that the consumers will
20 suffer substantial injury in the interim, in the meantime.

21 That's, I think, the principal concern in this
22 whole area. That's all the concern I think that underlies
23 the emphasize on marginal cost or variable cost, if you
24 will, versus fixed cost. Fixed costs are variable over the
25 long term, there's no question about that, Carl. But how

1 long should the Agencies as public enforcement Agencies
2 tolerate that long term? That's really to me the central
3 question. That's the question we need to address in any
4 kind of revision of the Merger Guidelines, to take into
5 account these dynamic markets.

6 PROFESSOR SHAPIRO: Well, I think this is moving
7 us forward. I'm happy to say there seems to me there's a
8 fair bit of consensus while some differences about things
9 that could be quite useful and improvements on the
10 Guidelines. How far one could go is not clear maybe.

11 I feel like we should stop because it's after time
12 and people probably want to get moving to wherever they're
13 going next. So let me really thank the panelists for a
14 wonderful session, for bringing so much to us, and thank you
15 all for attending.

16 You can always go to the FTC website. There will
17 be a transcript eventually, the other workshops, and we're
18 always welcome to hear more from you. So thank you all, and
19 join me in thanking the panel.

20 (Applause.)

21 **(The Workshop was adjourned at 5:19 o'clock p.m.)**

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