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ROUNDTABLE ON THE ROLE OF EFFICIENCY CLAIMS IN ANTITRUST PROCEEDINGS

-- Note by the Delegation of the United States --

This note is submitted by the delegation of the United States to the Competition Committee FOR DISCUSSION under Item XII at its forthcoming meeting to be held on 24-25 October 2012.

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**ROUNDTABLE ON THE ROLE OF EFFICIENCY CLAIMS
IN ANTITRUST PROCEEDINGS**

-- Note by the United States --

1. Introduction

1. The antitrust enforcement agencies in the United States (the Federal Trade Commission ("FTC") and the Antitrust Division of the Department of Justice ("DOJ"), collectively the "Agencies") have long recognized that consideration of efficiencies in the analysis of both mergers and non-merger conduct is an important part of proper competition analysis. In both types of cases, efficiencies may offer an explanation for the activity, and may show how it will benefit consumers and increase consumer welfare. The Agencies therefore consider efficiencies when evaluating whether a merger or conduct on balance harms competition.

2. With respect to mergers, demonstrating efficiencies allows the merging companies to provide the Agencies with a legitimate rationale for the proposed transaction that does not involve increased profitability through exercising additional market power obtained through the merger. Efficiencies from the transaction may increase the firm's ability to compete, and may benefit consumers through lower prices, improved quality, enhanced service, or new products.[1]

3. With respect to non-merger conduct, the company or companies involved may present efficiencies as a procompetitive justification for the conduct that is being evaluated for its anticompetitive effects. Agreements between competitors may allow the companies to deploy assets more efficiently, bringing products to market more quickly, at lower cost, or with higher quality. Agreements may also provide incentives to make output-enhancing investments.[2] Such agreements may, however, have anticompetitive effects in some circumstances. Thus, as explained in Section III/C. of this note, the Agencies consider both the efficiency justifications and the anticompetitive effects of the conduct to determine whether the conduct is procompetitive or harms competition.

4. Although the Agencies consider procompetitive efficiencies with respect to many types of agreements, U.S. law does not allow for the consideration of procompetitive efficiencies for certain agreements that always or almost always raise price or reduce output, such as price- or output-fixing agreements, agreements to allocate markets, and bid-rigging agreements.[3] Such agreements are treated as *per se* illegal, and courts evaluating such conduct will not consider arguments that such agreements may provide efficiencies.

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1 *See* U.S. Dep't of Justice and Federal Trade Comm'n, *Horizontal Merger Guidelines* (hereinafter Merger Guidelines) § 10 (2010), *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf.

2 *See* U.S. Dep't of Justice and Federal Trade Comm'n, *Antitrust Guidelines for Collaborations Among Competitors* (hereinafter Competitor Collaboration Guidelines) § 2.1 (2000), *available at* http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf.

3 *See, e.g., Nat'l Soc'y of Prof'l Eng'rs v. FTC*, 435 U.S. 679, 692 (1978).

5. For single-firm conduct, efficiencies also may offer a procompetitive justification for the conduct that is being evaluated. Various forms of unilateral conduct, including exclusive dealing, tying, and loyalty discounts, may have procompetitive benefits, such as obtaining economies of scope, improved product quality or functionality, or lower prices for consumers. On the other hand, such conduct can also, in certain circumstances, harm competition. Accordingly, as with agreements, the Agencies, as well as U.S. courts, evaluate such conduct by considering both the anticompetitive effects and the procompetitive justifications offered by the company.

6. Typically evidence of potential efficiencies is in the hands of the merging parties or companies being investigated for anticompetitive conduct.[4] Accordingly, the Agencies expect that the merging parties will bring forward evidence of efficiencies. Similarly, in a case involving unlawful conduct, the companies charged with anticompetitive conduct are expected to advance any procompetitive justifications for the conduct.[5]

7. The Agencies do not consider efficiencies that are vague, speculative, or cannot reasonably be verified.[6] Thus, generic predictions of cost savings or increased output generally will not suffice to establish efficiencies.[7] Rather, a company must establish through concrete evidence that the efficiencies are likely to be realized.

2. Types of Efficiency Claims

2.1 Mergers

8. At the broadest level, mergers (or integrated joint ventures) may result in efficiencies that allow the merging firms to lower their costs, to offer a new or improved product, or to offer increased innovation.[8] All of these efficiencies benefit consumers and are taken into account by the Agencies when attempting to assess a merger's likely impact.[9] Efficiencies achieved by the merging parties may in turn induce their competitors to attempt to achieve their own efficiencies.[10]

9. Firms can reduce their costs by (1) combining complementary assets, (2) eliminating duplicate activities, or (3) achieving scale economies.[11] Cost savings may accrue to the firm's variable costs or fixed costs. Variable costs are those costs which vary with a firm's change in output (*e.g.*, raw materials are typically a variable cost), whereas fixed costs are those borne by a firm regardless of its level of output (*e.g.*, a fixed-term lease for the firm's office space). Variable cost savings, once achieved, do not in turn spur other cost savings and so they are often called "static efficiencies."

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4 *See, e.g.*, U.S. Dep't of Justice and Federal Trade Comm'n, *Commentary on the Horizontal Merger Guidelines* (hereinafter Commentary) at 50 (2006), *available at* http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf.

5 *United States v. Microsoft Corp.*, 253 F.3d 34, 59 (D.C. Cir. 2001) (en banc); *United States v. Visa U.S.A., Inc.*, 344 F.3d 229, 238 (2d Cir. 2003); *Polygram Holding, Inc. v. FTC*, 416 F.3d 29, 36 (D.C. Cir. 2005).

6 Merger Guidelines § 10.

7 *Id.*

8 *Id. See also* Commentary, at 49.

9 Merger Guidelines § 10.

10 Commentary, at 49.

11 *Id.*

10. A firm's level of output is set at the point at which its marginal cost equals its marginal revenue. Reductions in a firm's marginal cost will lead to a higher level of output which, all else equal, leads to a lower price. Because marginal costs are affected by variable (but not fixed) costs, variable cost savings are more likely to result in a reduction in price than fixed cost savings. Therefore, efficiencies gained from variable cost reductions are generally more likely to immediately result in lower prices than efficiencies gained from fixed cost reductions.[12] However, some fixed cost savings may in fact result in short-term price reductions (*e.g.*, when selling prices are determined on a cost-plus basis that incorporates fixed costs).[13] Additionally, fixed cost savings may also result in lower prices, but in the longer term.[14]

11. Mergers may also allow the merging firms to combine complementary assets or capabilities in order to offer new or improved products or processes, or to increase the level of innovation. For example, the FTC closed its investigation of Genzyme Corp.'s acquisition of Novazyme Pharmaceuticals, Inc. because the merger accelerated the development of drugs that treated Pompe disease.[15] In particular, each firm had unique capabilities and technologies, and it was the combination of the capabilities and technologies that would accelerate innovations in the treatment of Pompe disease.[16] Because a given product improvement or increase in innovation can in turn spur further product improvements or increases in innovation, these sorts of efficiencies are often called "dynamic efficiencies."[17]

2.2 Non-Merger Agreements and Conduct

12. Outside the merger context, procompetitive justifications and efficiency claims vary greatly, depending on the conduct or competitor relationship at issue. Arrangements that are identified as *per se* illegal (*i.e*., those that "always or almost always tend[] to raise prices or reduce output") are illegal regardless of any claimed business purpose or procompetitive justification.[18] Nonetheless, the Agencies recognize that many collaborations between competitors, such as professional associations, licensing arrangements and strategic alliances, have procompetitive benefits, usually stemming from the pooled resources of two or more otherwise competing entities.[19]

13. Benefits from competitor collaborations are specific to the nature of the relationship itself; they may include lower production costs through the combined achievement of economies of scale, quality improvements generated through complementary capabilities between two firms, or accelerated innovation through combined research activities.[20] Courts, also, have acknowledged efficiencies and procompetitive

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12 *Id.*, at 57.

13 *Id.*, at 58.

14 *Id*.

15 FTC Press Release, FTC Closes its Investigation of Genzyme Corporation's 2001 Acquisition of Novazyme Pharmaceuticals, Inc. (Jan. 13, 2004), *available at* http://www.ftc.gov/opa/2004/01/genzyme.shtm. *See also* Commentary, at 53.

16 *See* Commentary, at 53.

17 Statement of Steven C. Salop, "Efficiencies in Dynamic Merger Analysis," Hearings on Global and Innovation Based Competition, Nov. 2, 1995, *available at* http://www.ftc.gov/opp/global/saloptst.shtm.

18 *See* Competitor Collaboration Guidelines, at § 3.2.

19 *Id*., at § 2.1.

20 *Id*.

benefits stemming from horizontal agreements between competitors, including reduced transaction costs, increased consumer choice, and increased quality of care.[21]

14. In addition, courts have long recognized that efficiencies may result from non-price vertical restraints, whether they result from unilateral conduct or pursuant to a vertical agreement. For example, exclusive dealing arrangements have been held to, among other things, create a stable supply and predictable prices for retailers, allowing them to reduce costs.[22] In *Continental T.V. v. GTE Sylvania Inc.*, the Court found that non-price vertical restraints can reduce or eliminate free-riding, which, in turn, may encourage benefits such as retailer investment in services and promotional efforts and more options for consumers.[23]

3. Assessing Efficiency Claims

3.1 Evidence and Proof Issues

15. The bulk of the information necessary for the Agencies to accurately assess parties' efficiency claims is in the hands of the parties themselves. Therefore, the burden of production on efficiencies rests with the parties to the merger, both in the investigation and the litigation context.[24]

16. Once the parties have supplied the Agencies with the information they believe substantiates their projected efficiencies, the Agencies will integrate their assessment of the projected efficiencies into their analysis of the merger's likely competitive effects. The Merger Guidelines note that "efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are not great."[25] Additionally, "[e]fficiencies almost never justify a merger to monopoly or near-monopoly."[26]

17. If the Agencies elect to challenge a matter in court, the parties may offer evidence of the merger's likely efficiencies to establish that the merger is procompetitive, and that the Agencies' evidence offers an inaccurate prediction of the merger's likely effect.[27] However, if the Agencies make a strong *prima facie* showing of likely competitive harm, one court has said that the parties must offer "proof of extraordinary efficiencies."[28]

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21 *See, e.g., Paladin Assocs. v. Montana Power Co.*, 328 F.3d 1145 (9th Cir. 2003) (holding that five-year assignments of natural gas transportation between competitors had sufficient procompetitive benefits, including reducing transaction costs and increasing consumer choice).

22 *Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 724 (1988) (citing *Cont'l T.V. v. GTE Sylvania Inc.*, 433 U.S. 36, 52 n.19 (1977)) (noting that non-price vertical restraints on trade have "real potential to stimulate interbrand competition"); *Stop & Shop Supermarket Co. v. Blue Cross & Blue Shield*, 373 F.3d 57, 62 (1st Cir. 2004) (noting that "because [exclusive dealing] agreements can achieve legitimate economic benefits (reduced cost, stable long-term supply, predictable prices), no presumption against such agreements exists today."). More recently, in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, the Supreme Court held that vertical price restraints may also have procompetitive justifications. 551 *U.S.* 877, 907 (2007).

23 433 U.S. at 54-55.

24 *See* Merger Guidelines § 10; *see also* Commentary, at 59.

25 Merger Guidelines § 10.

26 *Id.*

27 *FTC v. Staples*, 970 F.Supp. 1066, 1088 (D.D.C. 1997).

28 *FTC v. Heinz*, 246 F.3d 708, 720 (D.C. Cir. 2001).

3.2 Specific Criteria for Assessment in Merger Cases

18. According to the Merger Guidelines, "[t]he Agencies will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive."[29] "Cognizable" efficiencies are (1) merger-specific, (2) verified, and (3) "do not arise from anticompetitive reductions in output or service."[30]

19. Although the Merger Guidelines do not explicitly require cost savings be passed on to consumers, they do note that "[t]he greater the potential adverse competitive effect of a merger, the greater must be the cognizable efficiencies, and the more they must be passed through to customers, for the Agencies to conclude that the merger will not have an anticompetitive effect in the relevant market."[31] Accordingly, the Agencies focus on ultimate effects on consumers.

20. Merger-specific efficiencies are "likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of . . . the proposed merger." Alternative means of accomplishing the efficiency (*e.g.*, a joint venture or a contractual arrangement) must be "practical in the business situation" and not "merely theoretical."[32] The Commentary to the Merger Guidelines provide an example of an efficiency that was not merger-specific in the case of merging firms that proposed achieving cost savings by consolidating their packaging facilities.[33] One of the merging firms planned to close some of its packaging facilities and shift the volume to other packaging facilities that it currently owned, and not to a packaging facility then owned by the other party to the transaction.[34] Because this cost saving could occur without the merger, it therefore did not meet the merger-specificity requirement.[35]

21. Verification of efficiencies means the Agencies must be able to verify "by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), [and] how each would enhance the merged firm's ability and incentive to compete."[36] Efficiencies are most likely to be substantiated when they are analogous to past experiences.[37] The Agencies will not consider efficiency claims that are "vague, speculative, or otherwise cannot be verified by reasonable means."[38] Since cost savings are both quantifiable and under the control of the merging parties, they are less likely to be vague and speculative. On the other hand, the realization of dynamic efficiencies often depends in part on events out of the control of the merging parties, and likely to be achieved further into the future. Therefore, dynamic efficiencies are likely to be more speculative than cost savings.

22. Achieving some efficiencies may require up-front expenditures. Such efficiencies are assessed net of any cost required to achieve them.

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29 Merger Guidelines § 10.

30 *Id*.

31 *Id*.

32 *Id*.

33 *See* Commentary, at 52-53 (citing Fine Look—Snazzy, Disguised FTC Matter).

34 *Id*.

35 *Id*.

36 Merger Guidelines § 10.

37 *Id*.

38 *Id*.

23. Projections of cost savings may include savings that are not expected to be realized immediately. Such delayed cost savings are less likely to be realized, because the assumptions underlying the projections may change with time. Therefore, delayed cost savings are given less weight than cost savings that are projected to be achieved in the near term.

24. Additionally, efficiencies that are achieved by a reduction in output or service are not considered cognizable.[39] For instance, cost savings achieved by eliminating sales staff are likely to result in a reduction in customer service, and therefore are less likely to qualify as cognizable efficiencies.

25. Generally, the Agencies will challenge a merger that has anticompetitive effects in any relevant market.[40] However, the Agencies reserve the discretion to "consider efficiencies not strictly in the relevant market, but so inextricably linked with it that a partial divestiture or other remedy could not feasibly eliminate the anticompetitive effect in the relevant market without sacrificing the efficiencies in the other market(s)."[41] The Agencies will be more likely to credit such "out-of-market" efficiencies "when they are great while the anticompetitive effect in the relevant market(s) is small."[42]

3.3 Specific Criteria for Assessment in Non-Merger Cases

26. The Agencies will consider efficiencies claims and procompetitive justifications for competitor collaborations that are found to cause, or are likely to cause, competitive harm, but are not *per se* illegal.[43] The evaluation of efficiencies parallels the Agencies' approach to efficiency claims in merger cases. The efficiencies must be "cognizable," that is: verified, not resulting from a restriction in output or services, and unable to be achieved through practical, less restrictive means.[44] The cognizable efficiencies are also net of the costs of achieving them and of the competitor agreement itself.[45]

27. An important element of the Agencies' analysis is that the competitor agreement be "reasonably necessary" to achieve the asserted efficiencies.[46] In evaluating whether the agreement is overbroad or unnecessary, the Agencies generally consider whether there are practical, realistic business alternatives that can achieve the same benefits.[47] Factors that may be relevant are the duration of the agreement and its necessity to prevent opportunistic conduct that may thwart procompetitive aims.[48]

28. Courts rely on a "rule of reason" analysis to evaluate competitor agreements that are not *per se* illegal. Although the specific formulations vary, courts usually apply some version of a burden-shifting framework: after a plaintiff has established an anticompetitive effect, the defendant may rebut with evidence of the agreement's procompetitive virtues; in response, the plaintiff may offer evidence that there are less restrictive means of achieving the asserted benefits or that the agreement is not reasonably

39 *Id*.

40 Merger Guidelines § 10, n. 14.

41 *Id*.

42 *Id*.

43 *See* Competitor Collaboration Guidelines, at § 3.36.

44 *Id*.

45 *Id*.

46 *Id*., at § 3.36(b).

47 *Id*.

48 *Id*.

necessary.[49] Some courts apply a fourth "balancing" factor to the analysis, weighing the overall harm against the gain.[50] However, courts will reject a procompetitive justification for anticompetitive conduct that is pretextual (*i.e.*, that did not actually motivate the business to act the way it did).[51]

29. Importantly, the procompetitive justifications of efficiencies must depend on the challenged conduct itself, and not simply be permissible or desirable goals that can be achieved through other means.[52] Courts may also reject claims that fail to demonstrate that consumers genuinely benefit from the conduct, for example, where a restraint is justified solely by the need to preserve a firm's profitability or reduce its costs.[53]

30. In unilateral conduct cases, some courts have used a similar burden-shifting analysis, as in *United States v. Microsoft*.[54]

4. Ex-post Assessment of Efficiency Claims

31. 31. In reviewing mergers, the Agencies evaluate efficiency claims made by the parties that may counter or outweigh the anticipated anticompetitive effects from the merger. In most investigations, the mergers under scrutiny are proposed, not consummated, so that claimed efficiencies are conjectural. In a relatively small proportion of investigations, the mergers under scrutiny have been consummated, making it possible to take into account at least some of the actual effects of the merger, including efficiencies, in an overall assessment of its consequences.

32. Under certain conditions, ex-post evaluations of efficiency claims may be possible, and such evaluations may even be relevant to the prospective assessment of efficiency claims in investigations of proposed mergers. The use of ex-post evidence of efficiencies occasionally becomes possible in situations in which the parties to a merger under review are making efficiency claims which, if valid, might be expected to have resulted from other mergers between similarly situated parties in the same or similar industries as in the merger under review. If parties to a proposed merger are claiming that the merger would generate efficiencies of the type that could be expected to have been generated by previous mergers,

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49 *See, e.g., Care Heating & Cooling, Inc. v. Am. Standard, Inc.*, 427 F.3d 1008, 1012 (6th Cir. 2005); *United States v. Visa U.S.A., Inc.*, 344 F.3d 229, 238 (2d Cir. 2003); *County of Tuolomne v. Sonora Community Hospital*, 236 F.3d 1148 (9th Cir. 2001); *CDC Techs., Inc. v. IDEXX Labs. Inc*., 186 F.3d 74, 80 (2d Cir. 1999); *Law v. NCAA*, 134 F.3d 1010, 1021 (10th Cir. 1998).

50 *Wellnx Life Sciences Inc. v. Iovate Health Sciences Research Inc.*, 516 F. Supp. 2d 270, 289 (S.D.N.Y. 2007). Courts have also approved a burden-shifting framework that assumes that certain types of "inherently suspect" conduct are anticompetitive. *See Polygram Holding, Inc. v. Federal Trade Commission,* 416 F.3d 29 (D.C. Cir. 2005) (affirming Federal Trade Commission decision holding that distribution and marketing agreement between record companies was inherently suspect and not justified by need to enhance long-term profitability); *see also Realcomp II v. Federal Trade Commission*, 635 F.3d 815 (6th Cir. 2011) (affirming Federal Trade Commission decision holding that restrictive policies of real estate broker association were inherently suspect lacked adequate procompetitive justifications).

51 *Image Technical Servs. vV. Eastman Kodak Co.*, 125 F.3d 1195, 1219 (9th Cir. 1997).

52 *North Texas Specialty Physicians v. Federal Trade Commission*, 528 F.3d 346 (5th Cir. 2008) (finding that physician organization failed to demonstrate that asserted efficiencies were dependent on its price-fixing activities).

53 *Polygram Holding, Inc.*, 416 F.3d at 38 (holding that "a restraint cannot be justified solely on the ground that it increases the profitability of the enterprise introducing [a] new product").

54 *U.S. v. Microsoft,* 253 F.3d 34, 58-59 (D.C. Cir. 2001) (requiring four-part burden-shifting framework for conduct allegations).

then retrospective evidence bearing on whether past mergers did in fact generate efficiencies like those now being claimed by the parties may be relevant to an assessment of the parties' claims.

33. While ex-post evaluations have been made in a number of cases, the most extensive retrospective studies of merger efficiencies in the United States have been conducted in connection with hospital mergers. Parties to hospital mergers have often claimed that an important efficiency resulting from those mergers would be enhanced clinical quality.

34. Economists and medical clinicians have developed methods by which to measure the clinical quality of hospital services from available data. Several recent studies have used these methods to measure the effects of mergers on the quality of clinical services provided by US hospitals.[55] The studies show mixed effects on clinical quality from hospital mergers. In other words, there is no basis to presume that a particular hospital merger will improve quality of care. In fact, some studies observe the opposite effect. Similarly, one recent FTC challenge to a consummated hospital merger in the Chicago metropolitan area was based, in part, on direct evidence that clinical quality had either deteriorated or shown no improvement after the acquisition.[56] Given this evidence, the Agencies will not rely on generic claims that mergers between competing hospitals are likely to lead to improved clinical quality. Rather, parties asserting such clinical quality-related efficiency claims should base such arguments on persuasive, case-specific evidence demonstrating how and why such claimed improvements in clinical quality are likely to be achieved through the merger, and are not likely to be achieved in the absence of the merger.

55 *See, e.g.*, Mutter R.L., Romano P.S., Wong H.S., *The Effects of US Hospital Consolidations on Hospital Quality*, 18 INT'L J. ECON. BUS. 30 (2011); Town R., *The Effects of US Hospital Consolidations on Hospital Quality: A Comment*, 18 INT'L J. ECON. BUS. 30 (2011); W.B. Vogt and R. Town, "How Has Hospital Consolidation Affected the Price and Quality of Hospital Care?" Robert Wood Johnson Foundation Research Synthesis Report No. 9 (Feb. 2006), *available at* http://www.rwjf.org/files/research/15231.hospitalconsolidation.report.pdf; M. Gaynor and R. Town, "The Impact of Hospital Consolidation – Update", Robert Wood Johnson Foundation Research Synthesis Project Update (Jun. 2012), *available at* http://www.rwjf.org/content/rwjf/en/research-publications/find-rwjf-research/2012/06/the-impact-of-hospital-consolidation.html.

56 *In the Matter of Evanston Northwestern Healthcare Corp.*, Dkt. No. 9315, *available at* http://www.ftc.gov/opa/2008/04/evanston.shtm. *See also, e.g.*, Romano P.S. and Balan D.J., *A Retrospective Analysis of the Clinical Quality Effects of the Acquisition of Highland Park Hospital by Evanston Northwestern Healthcare*, 18 INT'L J. ECON. BUS. 45 (2011).