

L E C T U R E

on

COMPETITION POLICY

held at

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on

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Sir Derek Morris
(Chairman, Competition Commission)

Keynote Speakers:

Lars-Hendrik Roller
(The role of economic analysis under
the New Merger Guidelines)

Marc Ivaldi
(Empirical analysis of mergers
under the New Guidelines)

Michael Katz
(Is it time for the US to abandon
its Horizontal Merger Guidelines?)

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1 THE CHAIRMAN: Good evening, ladies and gentlemen. Welcome to the first
2 of what we intend will be a series of Competition Commission lectures
3 on Competition Policy. In a moment I will introduce the speakers but I
4 just want to spend two or three minutes giving a little background,
5 just three quick points.

6 As most of you in this room will know, competition policy in the
7 UK has undergone major reform in recent years, a revitalisation of the
8 regime, most obviously in The Competition Act 1998 and then of course,
9 more recently, The Enterprise Act. More generally, competition policy
10 is now accorded a very high policy priority by this Government. It had
11 a big effect on the Competition Commission as we operate under new
12 Acts, we have new powers, and there are new tests to apply. Some of
13 you will know that we have substantially reformed our procedures as a
14 result of The Enterprise Act, and we have more resources.

15 Along with The Office of Fair Trading and the Competition Appeals
16 Tribunal we are charged with delivering and maintaining, and I quote,
17 "a world-class competition regime". We take that objective very
18 seriously. We have sought, to that end, in the new regime to
19 incorporate what we think is the very best of the EC regime and the
20 very best of the UK regime and we hope that will work well in the UK.

21 Also, I must not let the moment pass without saying that it has
22 resulted in a new building. So let me welcome you all, for many of you
23 it will be your first time here at Victoria House. This is our first
24 large event in the building so it is something of a test of the
25 facilities. You are the guinea pigs for this, so I hope it works well;
26 we shall see.

27 Two other quick points. The international context in which we
28 work has changed quite substantially. There have been reforms of
29 regimes elsewhere of course, a growing number of countries are
30 introducing competition regimes and -- we will hear more about this in
31 a moment -- there is growing convergence of regimes, and so-called
32 modernization

33 of Articles 81 and 82, but, effectively, a de-centralisation

1 of its application, which will clearly have a similar effect in
2 emphasising the international dimension and degree of convergence.

3 Increasing comparisons made, and quite rightly so, between
4 different regimes and there are a number of networks emerging, the ICN
5 and others, of which we and other bodies in the UK are members of. All
6 of that is in addition to increasing cooperation on individual cases
7 where international, or indeed global, mergers are concerned. So the
8 international context is changing.

9 Finally, I would just like to say a word about transparency. We
10 have new procedures under The Enterprise Act. I believe, though you
11 must tell me, not immediately but later, if you think this is wrong,
12 that we now have a regime that is about 100% transparent. What I mean
13 by that is apart, of course, from material that is commercially
14 sensitive, everything is available to the parties typically by being
15 put on our website, provisional conclusions are published, draft
16 remedies are published; everything is in the public domain and
17 available to all, apart from commercially sensitive material. We
18 maintain the procedure that parties in front of us have direct access
19 to the decision-takers involved. We have become, I think, much more
20 open to the media and we have seminars and lectures. That really
21 brings me to this evening.

22 As part of these changes the new role of the Commission, the
23 international setting and the pursuit of transparency in the new
24 regime, we thought it would be very appropriate to launch a lecture
25 series, at least one and hopefully two such lectures a year and
26 tonight is the first one.

27 I am sure it is right we should focus on economics. Of course
28 there is a lot of law involved, but at the end of the day most of the
29 decisions we take are essentially economic decisions. So it is right
30 to focus on economics and, given what I have said, I think it is right
31 to have an international flavour. So we have three, I am bound to say,
32 very distinguished speakers tonight with different but highly-related
33 topics: Marc Ivaldi on my right; and Mike Katz on my left. I will

1 say a little more about them in just a moment.

2 Just before we start, there are I think four house notices. I am
3 going to ask each of them to speak fairly briefly. There will then be
4 an opportunity for a few questions related to each presentation and
5 then we will move on, and hopefully that will create a significant
6 amount of time at the end of the session when we can have any
7 questions/observations/discussion emerging from the set of three
8 presentations.

9 You will see there are no microphones. This room has what is
10 called a voice-enhancing system; that is, it is supposed to pick up
11 your voice and enhance it so that although one needs to project a
12 little, one does not need to shout. Of course the downside is that if
13 you whisper, "My God this is boring", it may pick it up so do be very
14 careful.

15 We are having a transcript taken and that will be available in
16 due course once it has been checked by the speakers. It will be
17 available on our website, but you will find order forms in your pack
18 if you wish to have a copy and, if you do order it, copies of the
19 slides that are going to be presented will be included with the
20 transcript.

21 When we get to questions, I think it would be helpful if you gave
22 your affiliation, where you are from, so that we know where the
23 question is coming from.

24 Those are the house rules.

25
26 THE CHAIRMAN: Let us now move on to our speaker, Marc Ivaldi is
27 another distinguished economist. He is Professor of Economics at
28 University of Toulouse. He has two doctorates which I think must be
29 fairly rare, both in Economics. He tells me one is in French and one
30 is in English and I was rude enough to ask if they were the same
31 doctorate! (Laughter) He assures me they are different.

32 He has done extensive research in competition economics-related
33 fields. He is an adviser to the Competition Directorate and he is

1 going to talk, and it follows I think fairly naturally on from the
2 first session, on empirical analysis of mergers under the new
3 guidelines, with reference to at least one or two particular cases.

4 Over to you, Marc, but if I could urge you, I am afraid, and I do
5 apologise for this, to shout because I do not think our voice
6 enhancement system is enhancing quite as much as we hoped.

7 PROFESSOR IVALDI: Thank you, Derek, for offering me the chance to
8 speak before this distinguished audience. First, I would like to
9 apologise because I changed the original title of my presentation. It
10 was too long and I wanted to focus on one point. I think that the text
11 on the new guidelines is not clear in fact: we are in between HHI or
12 SLC; but we owe already something to the action of the Chief Economist
13 and his team.

14 For the decision on Lagardere, that I am going to explain, there
15 is an explicit account of an econometric analysis of unilateral
16 effects in this decision. So I can interpret now the text of the new
17 guidelines in terms of this example. I think that we can say that it
18 is going to be in the jurisprudence that, on a big merger like that,
19 econometric analysis on unilateral effects has been done, and probably
20 in other smaller cases a study like that will be done.

21 This merger, it is a big merger. It is a French merger so it is
22 in French. It is on books so it was for this reason maybe I was asked
23 by the Commission to help them because I have a French doctorate and a
24 US doctorate. It is a merger that concerns France, Luxembourg and
25 Belgium. It stayed at Brussels. It was investigated by the DG COMP,
26 but of course probably several times the French authorities, I do not
27 want to explain who are the French authorities - I do not have time to
28 explain who are the French authorities - tried to get the case back in
29 Paris. Probably to show that the competition policy is now a very
30 strong element of the economic policy in France! But the case stayed
31 in Brussels.

32 This case is very interesting because it concerns different
33 groups. Lagardere is producing arms, it is producing planes but

1 | it is also in the book industry through Hachette and a publisher - in
2 | fact, it is a group of publishers, small publishers. Grasset, Stock,
3 | Livre de Poche, you may know that, are in fact small entities. One of
4 | the other groups is VUP, and that also has several elements.

5 | It is a very important aspect because this structure plays a
6 | crucial role on the decision at the end and the decision that has been
7 | taken by Lagardere. The case is very important also not only because
8 | there is a horizontal issue, it has very, very important vertical
9 | issues. Indeed, all these publishers are producing books, they send
10 | them to a platform and this platform sends the book back to
11 | bookstores. So these platforms are like essential facilities and of
12 | course you can imagine why these elements are very important. I am not
13 | going to discuss this question because there are a lot of things to
14 | say and I do not think that, as it is written, we have solved all of
15 | the problems with this aspect.

16 | Anyway, what I am going to speak about is the econometric
17 | evaluation of unilateral effect in this study. To do an econometric
18 | analysis, we need data and usually we have data from many, many
19 | markets, and in this particular year it is coming from a marketing
20 | firm, IPSOS, and we have the top 1,500 hardcovers published in 2002
21 | and all paperbacks, the top 5,000 paperbacks published or sold in 2002
22 | and we got volume, price, pages, author etc.

23 | After cleaning the database for some missing information, at the
24 | end we got 3,200 products that are going to be sold in three channels:
25 | small bookstores, supermarket and in-between, specialized shops, like
26 | Virgin, for instance. So in fact, it is about 10,000 products that
27 | are in the model. So we are going to look at the model to discuss the
28 | price and the quantity of these 10,000 products, a product being a
29 | book of a specific title sold in a specific channel of distribution.

30 | The model has two components: we have a demand side and it is
31 | going to be approximated by the usual nested logit model; and on the
32 | supply side, the group of publishers enter in Bertrand competition.

33 | This picture shows you the decision tree of the customer as

1 The market size is not fixed in this model. Because we have this
2 'outside' category, we have to evaluate what will be the potential
3 market, okay. For various reasons, it could have been between 50
4 million and 360 million. The value of 360 million books sold in a year
5 is the global market, i.e. all types of books. You can see on this
6 graph, on the dark blue line, that when it is 360 million units, the
7 merger has a real small effect, about less than 3%. Why is that?
8 Because, when you consider the potential market, it is like a adding
9 another competitor. So you can expect that when this competitor is
10 large, then the price due to the merger would be small. The pressure
11 of this competitor will be strong and the price increase cannot be
12 high.

13 In fact, the reasonable market size is around 100 million units
14 and so you see that we estimated that, for this market size, the
15 merger would increase the average price by 5%.

16 Notice one important point: The light blue line corresponds to
17 the price increase only for paperbacks. In our model we have
18 paperbacks and hardcovers. So the results mean that most of the price
19 increase is due to paperbacks. In fact, it is a way for us to show
20 that the case team was right when saying that paperbacks and
21 hardcovers are in two different markets. What happens on hardcovers
22 has not too much effect on the whole market.

23 I want to add an important point on what we can do. As soon as we
24 have chosen this 100 million units as a market size, then one can
25 raise the question of the relevance of the price increase. Is it
26 significant or not? What we did was to simulate the merger with
27 different parameters (by moving a little bit the parameters) and see
28 how this affects our evaluation. We made 1,000 runs of the merger for
29 different values and parameters. This method allows us to derive a
30 confidence interval. We can say that the risk that the price increase
31 due to the merger is not in the interval between 4% to 5.5%, is less
32 than 5%.

33 One more slide. During the case, Lagardere proposed remedies,

1 | that is to say, to sell some pieces of the group or more precisely not
2 | buying all the publishers of VUP. Then the merger effect is given by
3 | the rose line, below the blue line. At 100 million units the average
4 | price increase is 3%. If we account for some efficiency effect, the
5 | price increase could be even lower. So we see that the proposed
6 | divestiture would have solved the problem of anticompetitive effects
7 | of the merger.

8 | So to conclude, although the text of the guidelines are, to my
9 | point of view, ambiguous, the fact that they put this econometric
10 | analysis in the decision makes the guidelines, I would say, more
11 | visible and more understandable. What matters is to measure your
12 | market power in those cases.

13 | THE CHAIRMAN: Thanks very much. Any particular questions relating to
14 | this rather more coal face economics analysis of mergers? Yes, a
15 | question there.

16 | MR SIMON BISHOP: Simon Bishop from RBB Economics. In your model, every
17 | specification predicted a price increase, so I assume there were no
18 | cost factors taken into account in the simulation, and is there not a
19 | general point about these models that the theory should suggest that
20 | they are always going to show a price increase?

21 | In your presentation, you suggested 3% with a small increase and
22 | 5% was a more significant increase. Does that suggest a tolerance to a
23 | 2% or 3% price increase, or does it suggest an assumption about
24 | efficiency gains and how should models like this interact with those
25 | considerations?

26 | PROFESSOR IVALDI: It is just what I said. I did not present all the
27 | results. What of course we can do is to decrease the marginal cost of
28 | all books and do again the simulation to see how the various
29 | efficiency gains are passed through are passed to the consumer.

30 | The problem with this method is that it is ad hoc. We can
31 | simulate the effect of this merger if it decreases marginal costs by
32 | 1%, 2%, 3%. But we do not know the real value. In practice,
33 | efficiency gains should be endogenously determined.

1 We could add to the model a true cost function and, to some
2 extent, endogenise the efficiency gains in the sense that you can
3 generate economies of scales or economies of scope in production. But
4 we cannot take into account what Michael Katz calls merger-specific
5 efficiency.

6 THE CHAIRMAN: Do you want to come back?

7 MR SIMON BISHOP: If I could briefly come back. It seems to me this
8 kind of modelling is putting all of the emphasis ultimately on our
9 assessment of efficiencies in a case. So if I run any of these
10 unilateral effects models for a client, I am going to show a price
11 increase absent the efficiencies.

12 So could I go to Dr Roller and say I have modelled this and the
13 price increase is only 3% so that is okay, where the merger will lead
14 to a 3% price increase, because all of these models are going to show
15 some increase. So are we not effectively shifting the burden on to the
16 parties and then it all becomes an issue of measuring efficiencies and
17 marrying them up with the price increase?

18 PROFESSOR IVALDI: There are two answers. The one I did before. I
19 mean, we can add a cost function and, in some extent, endogenise these
20 efficiencies. I did not have time to explain how to do this. The
21 second reply is to look at what business managers are saying. Arnaud
22 Lagardere, the CEO of Lagardere, says that the proposed merger would
23 have decreased accounting marginal costs by 1.5%.

24 We can give some credit to such assessment, and measure the
25 impact of such decrease in marginal costs. Maybe only 40% or 60% of
26 this efficiency gain will be passed to consumers. Then the 3% price
27 increase due to the merger without efficiency gains should be
28 decreased by one percent and then we enter in a zone where the merger
29 is not harmful for the consumer and could be cleared by the
30 Commission. This is reasonable enough. However, there is indeed, a
31 priori no threshold on an acceptable price rise.

32 I want to come back to the first part of your sentence, "all
33 these models are going to show that there is a price increase."

1 This is true. But the magnitude of this price rise is not known and
2 there are many elements in this type of model that prevent us to say
3 that the price increase would be always large. The model is much more
4 flexible than we can think at the first glance. So that is more
5 important.

6 So if you estimate a large price increase, although I recall you
7 account for a potential competitor (the outside good), that is to say
8 you are very conservative for the merging firms, then I guess there is
9 a strong evidence against the case.

10 THE CHAIRMAN: I am conscious of the time. There is one more question,
11 but I think Mike wanted to come in briefly on that.

12 DR KATZ: Yes, I did want to come in briefly because it is a criticism
13 that is often put forward of unilateral effects models, particularly
14 the simulation models, that they will find an increase in price
15 absent efficiencies. But I actually think that is not a criticism of
16 the models, it is probably a statement of how the world works. I mean
17 if you just ask yourself the intuitive question, if you take away a
18 competitor and there is absolutely no gain in efficiency, is it likely
19 that that is going to lead to some, possibly very small, increase in
20 price? The answer is almost certainly yes.

21 The question is then where do you draw the line, or how do you
22 process it? I would say that in the US, we tend to let a lot of
23 mergers go through and thought oh well it is small enough without ever
24 setting the boundary. I think a lot of people have in mind that
25 somehow things that are small just are not worth worrying about which
26 I think is a mistake and does not stand up to any sort of analysis,
27 but I think the smart person's rationale for it, or rationalisation,
28 is the notion that typically there are some sort of efficiencies and
29 it is not the sorts we have been talking about with marginal cost
30 reductions.

31 Just a concern that if we potentially blocked everything and
32 shifted the burden of proof, you would be interfering with the market
33 for corporate control. So in addition to the sorts of

1 efficiencies we have been talking about, there would be concern that
2 managements would not be replaced or disciplined as much as they
3 should.

4 So the basic status in the US is that the vast majority of
5 mergers actually do get credited with efficiencies without anybody
6 ever having looked at efficiencies because the notion is there is
7 probably some base line level that there is enough of a gain there in
8 this generalised sense, that unless we see predictions of big price
9 effects, we just look the other way.

10 THE CHAIRMAN: One quick question if you would and a quick answer and
11 then we must head on.

12 MR ZOLTAN BIRO: Zoltan Biro, Frontier Economics. It was actually a
13 question to Professor Katz, if you do not mind, but related to this.
14 Very briefly, Professor Ivaldi has spoken about half the story in the
15 static sense because all the rivals' product positions and their
16 offerings are just taken as given in this modelling. There is
17 obviously a discussion that then follows about whether competitors
18 might reposition products.

19 I would like a sense from Professor Katz where there has been a
20 lot more of this modelling in the US, how much time and effort goes
21 into whether the price increases of 3% of 5%, in cases typically, or
22 actually whether the bulk of the conversation is then about the latter
23 discussion which is more about rival repositions and how they might
24 actually be affected by a merger, just some sense of where most of the
25 debate takes place and it will obviously depend on case to case.

26 PROFESSOR IVALDI: The debate actually should not be on whether a 3% or
27 a 5% price increase is small or large. It should be on the quality and
28 the robustness of the model.

29 THE CHAIRMAN: Let us move on to our next speaker, Michael Katz. He is
30 Professor of Strategy and Leadership at Berkeley and also a Professor
31 in the Department of Economics. Yet another speaker here with a very
32 distinguished career, he also served in the Clinton Administration as
33 Chief Economist at the Federal Communications Commission and also

1 ran the economic section -- I am not quite sure what the title was --
2 of the Justice Department's Antitrust Division I think until last
3 year. So you are most welcome, and over to you, Mike.

4 DR KATZ: Thank you. It is a pleasure to be here this evening as Sir
5 Derek's guest. I had the good fortune to be a student in a lecture
6 course Sir Derek held at Oxford many years ago. Although I usually am
7 terrible at remembering people, I remember Sir Derek quite clearly.
8 Even then, I was impressed with his desire to understand how markets
9 actually work, as opposed simply to theorizing about them.

10 I speak from experience when I tell you that, in academia, one
11 can have a fine career based on theorizing alone. But in applying
12 competition policy, it is essential to look at the facts. This does
13 not mean, however, that economic theory has no role to play in the
14 application of competition policy. Indeed, economic theory is
15 essential to sound policy enforcement. The world is too complicated
16 to be understood simply by staring hard at the facts, even if you
17 stare really hard. One must have a theoretical lens or analytical
18 framework.

19 In the United States, that framework is largely codified in the
20 *Horizontal Merger Guidelines*. My theme tonight is that there is a
21 danger that the *Merger Guidelines* are being used to replace common
22 sense with pseudo-science.

23 Now, I want to be very clear on this point, and I do not want to
24 be misunderstood about why I think this is a dangerous situation. I
25 am *not* here to speak in favour of common sense! (Laughter) Sense is a
26 good thing, but the strains of it that are common often are woefully
27 mistaken. For instance, it is common sense that the Earth is flat and
28 lies at the centre of the solar system. It is even common sense that,
29 if a firm pays a lot of money for its spectrum licenses or for
30 intellectual property, then that firm must consequently charge higher
31 prices than it otherwise would. But as any educated person knows, all
32 of those conclusions are false! (Laughter) Well, perhaps it depends
33 on where you were educated.

1 I come not to praise common sense, but to bury pseudo-science.
2 What is needed is sound economics, which can be used to convert common
3 sense into correct sense.

4 This evening, I am going to take an American perspective on these
5 issues for two reasons. First, I am American and, therefore, I don't
6 care what the rest of the world thinks (Laughter). Second, my friends
7 in other countries tell me that America's merger guidelines have had a
8 wide influence. To varying degrees, a large number of countries have
9 modeled their procedures on the *Guidelines* and, as such, there is a
10 broad international interest in their intellectual underpinning and
11 practical merits.

12 Now, I have been asked to be brief, and I have already used up my
13 allotted time to speak this evening. So let me give a concise answer
14 to the question posed by the title of my presentation: "Is it time for
15 the US to abandon the *Horizontal Merger Guidelines*?" The concise
16 answer is: "No."

17 Overall, the *Guidelines* have made a significant contribution to
18 improving the practice of merger policy. They have brought logical
19 structure and a certain degree of intellectual discipline to an
20 earlier process that, at times, had neither. In doing so, the
21 *Guidelines* have helped focus the central factual inquiries. At the
22 same time, however, there are areas in which merger policy would
23 benefit from changes in both the *Guidelines* themselves and how they
24 are applied.

25 Let me begin by discussing their application. I believe there
26 is a sense in which the *Guidelines* have been too successful. When
27 written, they were not intended to be the last word on merger
28 analysis. Some competition policy practitioners appear to have lost
29 sight of this fact and treat the *Merger Guidelines* as definitive. To
30 my mind, the *Merger Guidelines* are something like a home pregnancy
31 test. Both let you develop a sense of the likely outcome of an
32 important event in the privacy of your own home or office. But, like
33 a home pregnancy test, the *Guidelines* are no substitute for

1 | having a trained professional conduct a full examination.

2 | The *Merger Guidelines* play a very valuable role in providing
3 | some degree of predictability about merger policy enforcement that
4 | facilitates business planning and merger decisions. But that is a
5 | very different role than the one that some practitioners would thrust
6 | upon the *Guidelines*: offering a detailed roadmap of the one-and-only
7 | way to conduct merger analysis. The latter is a role that the
8 | *Guidelines* themselves reject. The *Guidelines* explicitly state they
9 | are not intended to describe how competition policy authorities will
10 | conduct the litigation of cases that they decide to bring.

11 | Indeed, when it comes to litigation, the American antitrust
12 | agencies do indeed on occasion depart from the framework set out in
13 | the *Guidelines*. To a cynic, the agencies' approach in litigation
14 | might be best described as follows: they will gerrymander the market
15 | definition until they can assert that the merger will reduce the
16 | number of genuine competitors from three to two; they will find that
17 | the market is tremendously concentrated; and they will assert that we
18 | all know that market share is all that really matters! (Laughter)
19 | However, I hope that even a cynic would agree that the agencies
20 | undertake a rather more sophisticated analysis in deciding whether to
21 | commence the litigation.

22 | Let me now turn to the economic content of the *Merger*
23 | *Guidelines*. Although I am tempted to skip over the issue in the
24 | interest of time, I cannot restrain myself from saying a few words
25 | about the welfare standard used in merger analysis. American merger
26 | policy is based on a consumer-welfare standard. This is a somewhat
27 | peculiar standard from an economics perspective, if for no other
28 | reason than it is so difficult to figure out who or what constitutes a
29 | "consumer" for these purposes. You might think "consumer" is a
30 | synonym for "buyer." If so, then you would be puzzled to learn that
31 | the *Merger Guidelines* have a section attacking gains in buyer welfare
32 | when these gains are attained through the creation of monopsony power.

1 In matters involving the sale of physician services and agricultural
2 products, the U.S. Department of Justice has evidenced concern for the
3 sellers' welfare, not the buyers'. So clearly "consumer" does not
4 mean "buyer," at least when the sellers are doctors or farmers.
5 Perhaps, you think to yourself, "consumer" means "household." This
6 interpretation has a certain appeal. After all, many doctors and
7 farmers live in houses and, in the matters to which I just referred,
8 the buyers were large corporations. But if the standard is household
9 welfare, then one is left wondering why the enforcement agencies
10 ignore the fact that households are owners and employees of merging
11 enterprises, not just customers. In any event, this muddle is not the
12 *Merger Guidelines'* fault. So let us move on and accept the consumer
13 welfare standard as *the* standard.

14 Applying the consumer-welfare standard, the central question of
15 merger analysis is this: Would the merging parties find it profitable
16 to offer significantly less value—which I will refer to in shorthand
17 as charging higher prices—to a significant number of consumers? The
18 *Merger Guidelines* offer a framework in which to go about answering
19 this question.

20 I think it is fair to say the centerpiece of the *Merger*
21 *Guideline's* framework is its market definition methodology. In fact,
22 a common view of merger litigation is that market definition is
23 everything; if the court decides in your favor on market definition,
24 then the court will very likely decide in your favor on the overall
25 merits of the case.

26 Taking a broad conception of market definition, market definition
27 is clearly something that needs to be done. What I mean here by
28 "broad conception" is that one needs to identify the competitors in
29 some fashion. Otherwise, one will not be able to develop a sense of
30 how competition works and how a proposed transaction might affect it.
31 To state matters differently, one must know which rivals stopped the
32 merging parties from raising prices and lowering consumer welfare
33 prior to the merger in order to understand how consumer welfare

1 | would be affected by the proposed merger.

2 | The *Merger Guidelines* define market definition in a much
3 | narrower sense. The *Guidelines* offer a specific algorithm for market
4 | definition based on the hypothetical monopoly test. It is this
5 | specific methodology and its practical application that I think are
6 | deserving of some criticism, not the broad concept of identifying
7 | competitors in order to understand competition.

8 | Under the *Merger Guidelines'* approach, the answer to the
9 | following question provides the basis of market definition: Would a
10 | hypothetical monopolist with control and ownership of a particular set
11 | of products be able to raise price profitably in a significant way,
12 | holding the prices of other products constant? Starting with one of
13 | the merging firm's products, the smallest set of products for which
14 | the answer to this question is "yes" constitutes a relevant market.

15 | Roughly speaking, application of the hypothetical monopolist test
16 | begins by taking a group of products and asking a certain question
17 | about them. We are just started, and already we have run into a bit
18 | of a problem. The hypothetical monopolist test talks about groups of
19 | products to define "the product market." But the test does not define
20 | what it means to be a product in the first place. While this may
21 | strike some a mere wordplay, I believe there is a serious underlying
22 | issue that arises in the case of mergers involving the producers of
23 | differentiated products. Absent an independent definition of what it
24 | means to constitute a product, products are identified at the outset
25 | with the specific firms that supply them. If one reads the *Merger*
26 | *Guidelines*, one finds that they describe a very different approach,
27 | under which products are defined in the abstract in a first stage. In
28 | a distinct second stage, one then determines which firms supply
29 | products in the relevant market. I believe that the breakdown in the
30 | distinction between defining relevant markets and identifying market
31 | participants undermines much of the potential value of the
32 | hypothetical monopolist test in structuring the overall inquiry.

33 | Indeed, one could go so far as to question why one inquires at

1 all about what a hypothetical monopolist might do. Rather than make
2 predictions about a hypothetical monopolist, why not make predictions
3 about actual suppliers? Specifically, why not ask directly whether
4 the merging parties would find it profitable to raise price by a
5 significant amount post merger? That is the question whose answer
6 matters for consumer welfare. If one possesses the answer to that
7 question, the answer to the hypothetical monopolist question is
8 completely superfluous.

9 So why does the hypothetical monopolist test play such a
10 prominent role in merger policy? From the perspective of economics, a
11 bad answer is that one must have some way to define a relevant market
12 because that is the only way that one can then calculate market
13 shares. I observe in passing that, although this is a bad answer from
14 the perspective of economic analysis, it may be a good one in terms of
15 meeting litigation burdens.

16 Another bad answer is the assertion that the hypothetical
17 monopolist test is needed in order to have a rigorous way to conduct
18 merger analysis. I, too, am in favour of rigour. And I do not want
19 my criticisms of the *Guidelines* to be used a justification to revert
20 to a situation in which various parties declare that market definition
21 is simply common sense and that "we know a market when we see one."
22 My concern with the *Guidelines* is not that they are too rigorous, but
23 rather that, in some instances, they provide a false sense of rigour
24 where none exists.

25 One must think carefully about the meaning of the question posed
26 by the hypothetical monopolist test. Properly applied, the test
27 indicates that, if a perfect cartel controlled a group of products,
28 then that perfect cartel would find it profitable to raise prices by a
29 significant amount for a significant amount of time for a significant
30 number of consumers. But one might ask: Who cares about what a
31 perfect cartel would do? In practice, one is very unlikely to
32 encounter a perfect cartel.

33 A more relevant inquiry would concern what an actual

1 cartel would do. And an actual cartel might need the cooperation of a
2 larger number of suppliers than would a perfect cartel. Thus, the
3 market boundaries relevant for assessing competition might be broader
4 than those determined through application of the hypothetical
5 monopolist test.

6 Of course, one could argue that a merged firm would behave like
7 a perfect cartel with respect to the products it supplies. Then, as
8 long as the transaction was a merger to monopoly, the hypothetical
9 monopolist test would apply. But if one is considering a merger to
10 monopoly, the hypothetical monopolist test and the "actual merging
11 parties test" are identical to one another.

12 There are other problems with the *Guidelines'* conceptual
13 framework when it is applied in an overly mechanical manner. For
14 instance, a distorted picture of competition can be painted by an
15 approach to market definition that labels a supplier as either
16 completely in or completely out of a market, where a supplier in the
17 market is given 100% weight and a supplier out of the market is given
18 zero weight in assessing competition. Actual markets often have no
19 such bright-line boundaries. Markets for differentiated products
20 often are better viewed as a continuum, where different products
21 compete with one another to varying degrees. The binary, in-or-out
22 approach that some take to market definition is misleading in these
23 settings.

24 Mechanical application of the hypothetical monopolist test can
25 lead to anomalous situations. I will not work through the math here,
26 but let me make reference to a couple of hypothetical examples as
27 illustrations of the potential problems. First, suppose one was
28 examining a market comprising ten firms that all competed with each
29 other in the supply of differentiated products. Moreover, suppose
30 that it turned out that putting any five of these suppliers under
31 common control would allow them to raise prices profitably and thus
32 qualify as a relevant market under the hypothetical monopolist test.
33 One must then ask which five are the relevant market? The *Merger*

1 *Guidelines* indicate that one of the merging suppliers should be
2 included in the five, but beyond that there are several degrees of
3 freedom. The fact that there are so many alternative definitions in
4 this case suggests that there is something wrong with the approach.
5 Moreover, some definitions will indicate that the merging parties are
6 competitors and some will find them to be in distinct relevant
7 markets!

8 Let me put names to the suppliers in a hypothetical example of
9 this last type of problem. That is, I will give state an example
10 involving actual firms that I think is plausible, but I want to treat
11 it as a hypothetical because I have not examined the relevant data.
12 The United States Department of Justice challenged the merger of
13 EchoStar and DirecTV, two companies that provide direct-to-the-home
14 satellite television services to American viewers. In the face of
15 that challenge, the private parties abandoned their proposed merger.
16 Now, if you were very literal-minded and had your little yellow book—
17 that is, your copy of the *Merger Guidelines*—you might have been
18 puzzled by the government's action. The reason your literal mind
19 would be puzzled is the following.

20 Suppose one conducted the relevant market exercise by the book.
21 One would begin with, say, the product offered by Direct TV and would
22 set out to find the smallest group of products including DirecTV's
23 product such that a hypothetical monopolist controlling those products
24 could raise prices profitably. So what product should be added to
25 DirecTV's in order to see if that is the smallest collection of
26 products that will work? The *Merger Guidelines* indicate that one
27 should include the next-best substitute, which is defined as the
28 alternative to which the most substitution would take place holding
29 the prices of all alternatives fixed. In this case, the next-best
30 substitute probably—and this is what makes this a hypothetical
31 example—was the local cable television company. Moreover, if Direct
32 TV and the local cable television company colluded, they could
33 probably raise the price significantly. Thus, through this

1 process one might reach the conclusion that DirecTV operated in a
2 relevant market in which the only two competitors were DirecTV and the
3 cable company.

4 A similar analysis might well lead to the conclusion that
5 EchoStar's closest competitor is the local cable television company
6 and that Echo Star and the local cable television company could
7 profitably raise price by a significant amount if they were under
8 common ownership.

9 So where does this literal application of the *Guidelines'*
10 approach leave us? DirecTV is in one market, and EchoStar is in
11 another. There is no horizontal overlap and—if one takes the mechanics
12 too seriously—no reason to challenge the merger.

13 Now, as you can guess, this logic did not sway anyone's thinking
14 about the likely competitive effects of the proposed merger. But it
15 does raise a troubling question: What is the point of this whole
16 methodology if one declares that, although it should always be
17 applied, whenever it gives the wrong answer that answer will be
18 ignored? If one already has an independent means of determining the
19 right and wrong answers, what does the formalism contribute to the
20 analysis?

21 This issue brings me to my next point. Another justification for
22 the hypothetical monopolist test is that it is a shortcut. By this
23 argument, the test helps us cut through a lot of analysis that we
24 otherwise would have to conduct. The test does this by examining an
25 admittedly artificial situation; the word "hypothetical" is in the
26 name of the test, so appropriate disclosures have been made. But, as
27 the EchoStar example illustrates, the test may not provide a
28 meaningful shortcut because one must still conduct a more complete and
29 less mechanical analysis of competition to determine whether the
30 hypothetical monopolist test is generating a sensible answer.

31 Many mergers concern suppliers of differentiated products and/or
32 raise issues of price discrimination markets and whether there are
33 various groups of consumers being charged different prices from one

1 another. In the presence of product differentiation and/or price
2 discrimination, the market definition exercise can become a huge
3 analytical effort in and of itself. I suspect that that effort might
4 well be better spent looking directly at competitive effects.

5 Please raise your hand if the term Diversion Ratio means anything
6 to you. (Show of hands) Well, at least now we know how many of you
7 are economists. In any event, for those of you who are not, just sit
8 quietly; this is an economics joke, so it will not be funny anyway!

9 (Laughter)

10 I am planning to introduce a new concept into the competition
11 policy lexicon. That concept is going to be known as the Attention
12 Diversion Ratio, or ADR. The ADR is defined as the percentage of
13 effort that should have been spent on competitive effects but instead
14 was spent on defining the relevant market.

15 Let me leave market definition. The fundamental question for
16 merger analysis concerns competitive effects: whether the merging
17 parties would find it profitable charge significantly higher prices to
18 a significant number of consumers. The answer to this question
19 depends on whether enough substitution would take place that raising
20 prices would not be profitable post merger. The extent of
21 substitution depends, in turn, on buyer preferences and the responses
22 of rival suppliers.

23 I will not here offer a full critique of the *Horizontal Merger*
24 *Guidelines'* approach to competitive effects analysis, but I will make
25 a couple of brief points about competitive effects. One, I believe
26 that the *Guidelines* make too much of the distinction between
27 unilateral and coordinated effects. Moreover, although the *Guidelines*
28 devote many words to unilateral and coordinated effects, I would argue
29 that the *Guidelines* fail to provide a meaningful definition of these
30 terms or an indication of their usefulness.

31 One source of doubt about the usefulness of this dichotomy is
32 that the *Merger Guidelines* indicate that both types of effect may be
33 present simultaneously. This is a statement that I have never

1 | understood, at least under a common interpretation of unilateral and
2 | coordinated effects. If unilateral effects are supposed to arise when
3 | static models are the correct way to think about an industry, and
4 | coordinated effects arise when dynamic models are the correct way to
5 | think about the industry, I do not see how sets of effects could be
6 | present at once. In addition to being puzzled, I don't think this is
7 | the only possible interpretation of unilateral and coordinated
8 | effects.

9 | Although I have not fully thought this through, I would like to
10 | propose an alternative approach as a basis for further consideration.
11 | The proposal runs along the following lines. First, forget about the
12 | hypothetical monopolist. Instead, conduct a first-stage test on the
13 | actual merging parties. Do this by asking whether, if the two parties
14 | were to merge and all other suppliers held their product prices
15 | constant and offered an unlimited supply of output at those prices,
16 | the merging parties would find it profitable to raise significantly
17 | some or all of their prices? It should be evident that this test
18 | borrows a number of elements from the hypothetical monopolist test.
19 | It also provides an assessment of what I believe many economists would
20 | call unilateral effects, at least in a model of price competition.

21 | A second stage of analysis would be to incorporate a more
22 | realistic model how the rivals would respond if the merging parties
23 | raised their prices. Instead of developing a single, "correct" model,
24 | one might conduct a sensitivity analysis to determine bounds on
25 | competitor behavior that would or would not prevent the merger from
26 | harming consumer welfare. In a sense, this second-stage analysis
27 | would play at least part of the role of coordinated effects analysis.

28 | I have spent some time this evening offering criticisms of
29 | various elements of the *Merger Guidelines'* analytical framework, or at
30 | least the way that it is applied in practice. I would now like to say
31 | a few words in defense of the *Guidelines* with respect to another line
32 | of criticism that has been leveled against them.

33 | The *Merger Guidelines* are based on a rational-actor model of

1 merging parties and their rivals. Specifically, merger analysis is
2 based on the assumption that the merging suppliers and their rivals
3 act to maximize their respective profits. Some critics have asserted
4 that the real world is more complicated than economists would have one
5 believe. For example, these critics assert that firms do not follow
6 the logic of profit maximization and based their prices on marginal
7 costs. Instead, it is argued, firms look to average costs as pricing
8 guideposts.

9 No doubt, the world is more complicated than most economic
10 models would admit. But one should be wary of claims to reform
11 competition policy by incorporating an ad hoc real-world understanding
12 of what happens.

13 It seems to me that one can summarise this debate as falling into
14 two polar positions. One pole is what a critic of current policy
15 might call "looking where the light is." This is the punch line to an
16 old joke about an economist who is looking for his keys under a street
17 lamp. An onlooker asks the economist, "Where did you lose your keys?"
18 The economist answers, "At the other end of the street." The onlooker
19 then asks, "If you lost them at the other end of the street, why are
20 you looking over here?" The economist replies, "Because that's where
21 the light is." (Laughter out of politeness only)

22 Now there certainly is a danger of being unrealistic in assuming
23 that suppliers behave according to the economic model of a profit-
24 maximizing, rational decision maker. And one should not make this
25 assumption simply because we know how to make it. However, before
26 abandoning this approach, one must think about what the alternative
27 is. Here, we come to the second opposite pole, which a friend of mine
28 has characterised as "playing tennis without a net." Indeed, one
29 might call it playing tennis without a net or any rules. Once one
30 abandons the assumption of profit-maximizing suppliers, how does one
31 rule out even the wildest of claims?

32 I believe that we will eventually have good answers to this
33 question. There are two sorts of departure from the assumption of

1 | profit-maximizing firms, and progress is being made in on both fronts.
2 | One is the assumption that the firm is a unitary decision maker. As
3 | recent corporate scandals demonstrate, managers do not always act in
4 | the interest of shareholders. Here, agency theory offers more
5 | realistic models of organizational decision making and provides
6 | insights into deviations from profit-maximizing behavior. To date,
7 | the main implication appears to be that managers may pursue non-
8 | profit-maximizing mergers in order to engage in what might be
9 | colloquially referred to as empire building. The other point of
10 | departure is that managers may not behave as rational economic agents.
11 | At present, a number of researchers in behavioural economics are
12 | integrating psychology into economics to develop more realistic models
13 | of human decision making. However, I don't believe we are yet at a
14 | point where these models are well enough developed to provide
15 | meaningful guidance to competition policy enforcers. This situation
16 | may change over the next few years, but we are not there yet.

17 | I want to point out, for those of you who take a defendant's
18 | perspective, that the "more realistic" view of how markets work is not
19 | necessarily good for defendants. Some people appear to believe that,
20 | if only competition authorities would take a more realistic view of
21 | markets, a lot fewer mergers would be challenged by policy enforcers.

22 | I believe there is a real possibility that the pendulum would swing
23 | in the other direction.

24 | Two examples illustrate what can happen if one abandons the
25 | hypothesis that firms act to maximize profits. The first example
26 | concerns vertical mergers. When a vertical merger is reviewed in the
27 | Unites States, something like the following sequence of events often
28 | takes place. An economist reviewing the merger find that, in theory,
29 | the vertical merger could lead to foreclosure of rivals but that, when
30 | one looks at the facts, one sees that it would not be in the merged
31 | firm's economic interest to foreclose. Consequently, the vertical
32 | merger is not challenged.

33 | Suppose that, rather than the profit-maximization model, an

1 alternative theory provided the underpinnings of merger policy.
2 Competition policy enforcers might take the position that the managers
3 of the merged firm would choose to engage in foreclosure even though
4 doing so would be against the firm's economic interest. For instance,
5 I teach in a business school, and it is clear that many of my students
6 would be inclined to engage in foreclosure even in situations where
7 economic theory indicates that doing so would not maximize profits.
8 Declaring themselves to be behavioural economists, competition policy
9 authorities might choose to oppose the vertical merger on the grounds
10 that this is how the merged entity's managers would behave. I think
11 that this would be a mistake because casual empiricism suggests that
12 most vertical mergers do not lead to prolonged foreclosure. Of
13 course, it would certainly be useful to study the issue more
14 systematically, and enforcement decisions should be made based on the
15 facts of the specific transaction under consideration.

16 A second example also makes the point that "realism" could lead
17 to much less permissive merger policy. Professor Michael Porter, who
18 is perhaps the leading scholar on competitive strategy, has at times
19 taken the position that the default in merger policy should be to
20 block a merger in the absence of good reasons to approve it because
21 most mergers are the result of poor managerial behaviour. For
22 example, under this view, managers seek revenue growth through merger
23 instead of doing their jobs and creating value organically. Here we
24 have a "real world" view of firm behavior leading to quite stringent
25 merger policy.

26 Yes, there is some danger in just looking where the light is.
27 But the dark is awfully scary, and we don't really yet know what
28 policy conclusions are lurking out there. By and large, the profit-
29 maximizing-firm approach to merger policy has been working, and it is
30 not time to abandon it yet.

31 I would like to conclude by saying how delighted I am to see
32 economists heading various British competition policy institutions. In
33 the United States, one would never see economists in comparable

1 | becoming very adversarial.

2 | I think that the development in this Commission, in particular,
3 | to make the economic analysis more sophisticated and to encourage the
4 | parties to participate in that process is very encouraging. But my
5 | comment really is that at some point, the parties, the authority may
6 | disagree and they may have to turn to the courts to resolve those
7 | issues. Unless we are in a position where the courts are also in a
8 | position to take more sophisticated decisions and to actually engage
9 | perhaps with the parties on a debate on those issues, we will actually
10 | find that we get precedents which are unhappy, both from an economic
11 | point of view and from a legal point of view.

12 |

13 | DR KATZ: My experience, rather limited, with Judges has been that they
14 | have been actually extremely hard-working and intelligent in really
15 | trying to understand the economics. I read decisions by other Judges
16 | where there is little evidence of those characteristics, but the
17 | Judges I have dealt with have tried to do that, but a real problem
18 | they have is that a lot of these things are not brought up to them by
19 | either side.

20 | For example, you could easily be in a case where both sides agree
21 | that market definition is not the issue and you should move beyond
22 | that, but each side is afraid to bring that point up because you would
23 | be running up against precedent and they are too worried that it would
24 | hurt their legal position. No one is willing to take the risk or
25 | somehow come up with an agreement and say, okay let's just go in front
26 | of the Judge and say we agree this is the right way to do it.

27 | I think someone is going to have to figure out a way to step
28 | forward and do that. Either that, or try and have some sort of thing
29 | to educate Judges directly. But even in that you are going to have, at
30 | least in the US system, not just the District Court Judges but then
31 | you have to get the Circuit Judges too because no District Court Judge
32 | wants to be reversed by a Circuit that has not gone to the class.

33 |

(Laughter)

1 THE CHAIRMAN: I think we should probably draw the formal part of this
2 evening to a close. I cannot resist saying that there was a case about
3 three years ago when the legal counsel for a company that was in front
4 of us in a merger case always referred to our quantitative analysis as
5 "economic tricks"! Every time it was "economic tricks", so at one
6 point I did say, "I think you have the em-far-sis on the wrong
7 sill-lable." (Laughter) After that, he corrected himself.

8 We have some food and drinks and refreshments, so discussion and
9 debate can go on. Just before I let you go, let me say some thanks.
10 You would, I am sure, want me to thank, first of all, our speakers.
11 They are from far-flung parts of the world. They have come here and I
12 do appreciate it. They have attracted a very large audience for our
13 first such occasion and I really do thank them very much on behalf of
14 the Competition Commission for that. They have, I think, stimulated
15 our thinking on a number of related issues. So thank you very much
16 indeed.

17 (Applause)

18 Secondly, I would like to make a special point of thanking those
19 who organised this occasion. I would like to mention in particular
20 Amanda Rowlett, who is the Chief Economist of the Competition
21 Commission. She arranged the programme, identified the speakers and,
22 more than that, actually persuaded them to come, so I thank Amanda and
23 also the administrative team. If I may just mention them because I
24 think they have been wonderful: Katie Stone, Marie-Louise Spiers, Mark
25 Miller and our Press team. I do thank you all for everything you have
26 done to organise this. Thank you.

27 (Applause)

28 One last thing: I would like to thank you all for coming. You do
29 not have to clap yourselves. I do hope you have enjoyed it and found
30 it worthwhile. Our next lecture, we are hoping, will be in the autumn
31 and that will be on a legal issue, with a distinguished member of the
32 legal profession speaking. Details will be available fairly soon and
33 we hope to see you there.

