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Economies of Scope in Mergers

When Significant Efficiencies and Easy Entry are Consistent

The concept of economies of scope may help to reconcile an apparent inconsistency in merger analysis. It has long been recognised that to argue both that a merger generates significant efficiencies and that it is not anticompetitive because entry barriers are low may be inconsistent. This arises because a merger which produces significant cost savings due to economies of scale implies that small-scale entry will not create a competitively significant supplier or be profitable. Recently, the Federal Trade Commission (FTC) in the Staples/Office Depot merger concluded that efficiency evidence submitted by the parties meant that entry by a new, cost-effective office supply superstore would be unlikely.

The Concept Defined

Economies of scale are present when the production cost of a particular product fall as the number of units produced increases. In contrast, economies of scope exist when an increase in the production of one product leads to a reduction in the production costs of another. For example, a railroad or airline may find it less costly to supply both passenger and freight transport than to specialise in only one service.

Economies of scope can exist in production, product development, and distribution. Most discussions of economies of scope have focussed on production processes. Manufacturers may be able to lower their costs by producing a variety of different products on the same equipment *e.g.,* using plastic injection moulding equipment to produce rubbish bins and towel dispensers. The added volume not only spreads fixed costs, thus lowering average total costs, but it may allow the firm to employ different equipment that has lower variable costs.

Economies of scope in product development have received less attention, but they may be significant. When common science, equipment, and know-how are used to develop two different products, both average variable costs and average fixed costs may be reduced by expanding the scope of research and development efforts.

Economies of scope may also exist in distribution. A firm that has established a warehouse infrastructure to distribute one type of product may be able to reduce its distribution costs by expanding the types of products it carries in inventory. Similarly, a firm such as a supplier of grocery products with a sales force that calls on particular types of customers may be able to lower per-unit sales costs by adding products to its product line.

The Competitive Significance

The existence of economies of scope may allow competitive discipline in a market in which a merger yields significant economies of scale. To the extent that economies of scope create well-positioned potential entrants, a post-merger price increase can be prevented. The merger of two leading producers of plastic rubbish bins, for example, may allow producers to realise efficiencies by shutting down an older injection moulding plant and increasing the capacity utilisation at a more modern facility. Even if this merger were to raise concentration significantly, it would not lead to post-merger price increases if numerous firms could divert their modern injection moulding capacity into the production of plastic rubbish bins. Under the US Department of Justice Merger Guidelines (and presumably in European law), these alternative suppliers would be viewed as competitors in the "rubbish bin market" if entry could be accomplished very quickly and with little incremental sunk expense. If their entry would take more time and incremental sunk investment, they would be viewed as potential entrants.

Makes Potential Competition Important

When significant economies of scope exist and the incremental costs associated with moving across product markets are low, a firm that does not currently produce a particular product may even exert more competitive pressure on the leading suppliers of a product than the "fringe" suppliers that already supply the relevant product. This could occur if the leading suppliers of related products have a cost structure that is more competitive than that of the existing "competitive fringe". Of course, crossing markets may not be low cost, or fringe competitors may be able to serve the relevant

market at comparable costs even though they are operating at a much smaller scale.

Mergers that are motivated by a desire to reap the benefits of economies of scale can occur in market contexts where barriers to entry are low. In particular, in markets where there are potential entrants who have "core competencies" and physical assets that make entry without significant incremental investment in sunk costs easy, merging firms may be able to benefit from the exploitation of economies of scale but still face potential competition from potential entrants that can exploit economies of scope.

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