

Efficiency in Mergers

Ignoring the tradeoff between efficiency and price increases

Mergers are a key feature of a competitive market economy because they improve the efficient allocation of resources. Yet in competition law, efficiency considerations are generally ignored or given low weighting. The “dumbing down” of efficiency has gained momentum among antitrust authorities in many countries, presumably in response to the onslaught by politicians and commentators that the “*market for corporate control*” does not usually achieve the efficiencies which even the shareholders of the merging companies anticipated. This has been reinforced by the view that allowing an “efficiency defence” would open the floodgates to highly speculative cost-accounting exercises used to justify increased dominance, thus undermining the pro-competition objectives of the law.

Williamson’s Cost-Price Tradeoff

In an important article Professor Oliver Williamson (1968) showed that a merger which increased market power could improve economic welfare if it resulted in cost savings. If the merger reduced costs then a trade-off existed between efficiency and any price increase which would result when the merger created or strengthened a dominant position. Williamson concluded that “*a merger which yields nontrivial real economies must produce substantial market power and result in relatively large price increases for the net allocative effects to be negative.*” To illustrate, he showed that under simplifying assumptions if costs fell by 5% to 10%, price increases of the order of 20% to 40% would be required to wipe out the economic benefits. While the implications for practical antitrust policy were cautiously drawn, the analysis strongly suggested that the enforcement authorities should take evidence of cost-efficiency seriously.

The Horizontal Merger Guidelines

The US Department of Justice/Federal Trade Commission *Horizontal Merger Guidelines* reflected the spirit of Williamson’s trade-off analysis. The 1992 and 1984 versions of the *Guidelines* both began by saying that the “*primary benefit of mergers to the economy is their efficiency enhancing potential*”. This left open the possibility that anti-competitive mergers might be allowed if the merger was necessary to achieve significant net efficiencies. To quote: “*some mergers*

that the Agency otherwise might challenge may be reasonably necessary to achieve significant net efficiencies.”

The downgrading of efficiency occurred in the 1997 revision to the *Guidelines*. First, the language was more overtly competitive - “*competition usually spurs firms to achieve efficiencies*” and less disposed to efficiencies which were described as “*difficult to verify and quantify*” and that even reasonable, good faith projections may not be realised. Such pessimistic language was not seen in the 1984 and 1992 versions. Secondly, the 1997 *Guidelines* linked efficiency to price reductions in a significant change from previous policy statements. The *Guidelines* state that efficiencies are not to be traded-off against enhanced market power, and are only relevant where they give the incentive and ability for the merged firm to lower prices, thereby leaving post-merger prices either unchanged or lower. Moreover, efficiency considerations are limited to those that “*do not arise from anticompetitive reductions in output or service.*” Read literally this rules out any efficiency defence.

Marginal Cost Efficiencies

The type of efficiencies that would give the merged firm an incentive to reduce prices are those likely to reduce marginal rather than fixed costs. Efficiencies that reduce short-run marginal costs may create an incentive for the merged firm to lower prices even if the firm has some market power. While the agencies can always exercise prosecutorial discretion, the 1997 *Guidelines* seem to indicate that if a merger raised serious competitive concerns, the agencies would give little or no weight to efficiencies that primarily affect fixed costs, even if significant resource savings were at stake. In the long run, of course, all costs are marginal, and the 1997 *Guidelines* do indicate that these types of costs will be considered. The 1997 *Guidelines* however have always had a short-term focus: market definition ignores long-term substitution possibilities, and entry that takes more than two years is considered irrelevant.

Role in Other Jurisdictions

The position in other jurisdictions varies considerably. In the UK efficiency is a factor taken into account in the more pragmatic approach which has characterised UK

competition law. The EU position is at the other extreme. The EU *Merger Regulation* does not permit economic efficiencies consideration to override competition concerns. This, paradoxically, was due to British pressure during the drafting of the Merger Regulation who feared that an efficiency defence would be used to subvert competition law in favour of old-style industrial policy by the EC Commission. The Commission has shown antagonism toward efficiency considerations concluding in *AT&T/NCR* (1991) that the parties' claims of costs-savings from complementarities between technical know-how and marketing of workstations would allow the merging parties to drive rivals out of the market. The Australian position is closer to that of the US. The Australian Competition and Consumer Commission (ACCC) may grant an authorisation giving legal immunity to a merger if it is satisfied that the merger results in a benefit to the public. Public benefits have been defined vaguely as "... *anything of value to the*

community generally, ... including as one of its principle elements ... the achievement of the economic goals of efficiency and progress." Efficiency can be argued in both the competitive analysis and 'public benefit' stages of the authorization process. The ACCC will only take efficiencies into account in its competitive analysis if the merged entity is better able to compete against incumbents. The ACCC, while recognising the benefits of resource savings, generally prefers that efficiencies be passed on to consumers in the form of lower prices or better quality before considering them to be a public benefit. On the other hand, the Australian Competition Tribunal has generally been more sympathetic to efficiency arguments.

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News & Commentary

Presentation to Italian Antitrust Authority

In early October 1998, Dr Cento Veljanovski was guest of the **Autorita Garante della Concorrenza e del Mercato** Rome where he gave a seminar on market definition in the telecommunications sector.

Australian Seminars

During September Dr Cento Veljanovski gave talks on developments in competition law to Australian competition and communications lawyers at a Case Seminar at the Wentworth Hotel, Sydney, and to the competition and communications practice of **Blake Dawson Waldron**, Sydney. Dr Veljanovski was also a guest of the **Institute of Public Affairs**, Melbourne where he gave a lunchtime talk on competition law and the media.

Talk to BT Regulatory Finance Group

Dr Veljanovski gave a talk to the Regulatory Finance Group of **British Telecom** on the evolving competition approach to market definition in telecommunications in the UK and EC.

Communications Sector Clients

Case continues its heavy involvement in the communications sector having recently assisted on a number of regulatory and competition law matters for clients such as **Worldcom/MCI, Cellnet, British Telecom, Telecom Eireann, Seagrams, Foxtel** and **Australian Radio Network**. Case's work has ranged from merger analysis, market definition, submissions to regulators on licence terms and access arrangements, to detailed modelling of the impact of further licensing of radio stations on industry profitability.

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