Dynamic Efficiencies and Merger Analysis

Alden F. Abbott
Deputy Director, Office of International Affairs
U.S. Federal Trade Commission
Dynamic Competition and Merger Analysis Panel Discussion
George Mason University Law and Economics Center
December 14, 2011
Introduction

• Dynamic competitive analysis of mergers raises a host of difficult questions
• After briefly explaining how I interpret the term “dynamic analysis” and its use in merger assessment, I will briefly note dynamic elements in the 2010 Horizontal Merger Guidelines, and then highlight FTC merger matters that have had dynamic aspects
• The views I express are solely attributable to me, they do not necessarily represent the views of the FTC or any FTC Commissioner
Dynamic Versus Static Analysis

• Static analysis focuses on competitive conditions in existing markets, assuming away innovation and related factors that dramatically alter industry characteristics.

• Dynamic analysis instead emphasizes how innovation may dramatically reduce costs (change production methods), create new markets (new/improved products and processes), and fundamentally change business models, thereby greatly raising welfare.

• But “dynamics” may also refer more broadly to how a significant competitive event, e.g., a merger, prompts changes in industry characteristics, through the achievement of efficiencies, product repositioning by existing firms, incentives to enter a market, etc.
Statics/Dynamics and Mergers

• Before 1982, U.S. antitrust enforcement agencies’ merger analysis emphasized perceived risk of harm due to increased market concentration, without careful assessment of industry-specific conditions.

• “Modern” horizontal merger guidelines (1982, 1984, 1992 (as amended in 1997), 2010) steadily moved away from strong presumptions of illegality based merely on concentration ratios, taking into account industry-specific facts, entry, efficiencies, etc., using an integrated approach (see also 2006 Commentary on the Horizontal Merger Guidelines).
Dynamics and HMG

• In short, although agency horizontal merger assessments today retain important static features (UPP and SSNIP methodologies, for example), they are “dynamic” in the sense that they examine how market interactions and industry characteristics would be affected (and perhaps transformed) by a proposed merger.

• Current analysis takes heed of the *General Dynamics* (1974) teaching that a close look at industry specifics (long term contracts) may show that a simple static measure (in that case, current sales/market share) may badly misrepresent the actual competitive effects of a merger.
Merger Dynamics: Key Points

• In short, “dynamic” analyses of proposed mergers raise various considerations
• Concern for new products/processes may call for a focus on IP licensing, R&D
• Tomorrow’s market may look very different from today’s market – requires caution
• Dynamics do not necessarily involve product change – can come on cost side (e.g., in chemicals industry, foreign firms’ near term ability to reduce cost and raise quality may discipline effects of domestic consolidations)
The 2010 HMG further move agency analysis in a “dynamic” direction, e.g.:

– They use fact-specific, fluid analysis (e.g., § 1)
– They do away with the 2-year time limit on committed entry (§ 9)
– They explain that market definition is not a rigid deterministic procedure or end in itself and should be applied flexibly (§ 4)
– They discuss the effects of a merger on innovation in addressing efficiencies (§ 10)
2010 HMG, § 10

- 2010 HMGs’ treatment of innovation and efficiencies embodies complexities
- Merger efficiencies may spur innovation but not affect short-term pricing
  - Willingness to weigh longer-term benefits
- R&D cost savings may be large yet not cognizable because they are hard to verify or result from anticompetitive reductions in innovative activities
  - Focus on nature and likely effects of R&D
- Statement that licensing and IP conditions important to appropriability, and thus to incentives to innovate
  - Recognition that ability to appropriate rents through IP restrictions may enhance innovation and consumer welfare
FTC Cases Prior to 2010 HMG

• FTC merger enforcement matters prior to the 2010 Guidelines show a willingness to look at hard market facts and dynamic industry changes, and not rely on mere static analysis.

• The FTC has allowed mergers to proceed in highly concentrated industries when conditions warranted it, and has structured settlements to allow merger efficiencies to be realized while at the same time ensuring that innovation competition is protected.
Boeing/McDonnell Douglas (1997)

• The FTC takes to heart the Supreme Court’s *General Dynamics* focus on market realities, not just shares.

• The FTC decided not to challenge the Boeing/McDonnell Douglas merger (1997), despite Boeing’s 60% share of the large commercial aircraft market (Airbus and McDonnell Douglas were the only other producers).
  – Although a purely static analysis would have favored blocking the merger, the FTC stated that “the absence of any prospect of significant commercial sales, combined with a dismal financial forecast, indicated that Douglas Aircraft is no longer an effective competitor, and there is no prospect that position could be reversed” (no failing firm finding, instead an assessment of market dynamics).

• Dynamic analysis appears in the FTC’s decision not to challenge the 2001 merger between the only 2 firms carrying out R&D into pharmaceutical products for a rare life-threatening children’s ailment (Pompe Disease) for which no cure existed (Genzyme-Novazyme, investigation closed in 2004)

• Eschewing a static “merger to monopoly” assessment, FTC Chairman Muris concluded that on balance this transaction likely would be procompetitive, based on his dynamic assessment of the incentives of the post-merger entity to carry out R&D that would likely yield therapies beneficial to patients – results as good or better as in a world without the merger (see dissenting statement by Commissioner Thompson)

- FTC complaint alleged harm to innovation markets where the merging parties – Glaxo and Burroughs Wellcome – were the two firms furthest along in developing an oral drug to treat migraine attacks
  - Alleged elimination of actual R&D competition on migraine remedies and increase in Glaxo’s unilateral ability to reduce R&D of these drugs
- Combined firm required to divest Wellcome’s R&D assets re migraines, including patents, testing data, technology, manufacturing information, research materials, and customer lists, plus inventory required to complete FDA trials, studies
Ciba-Geigy, 123 F.T.C. 842 (1997)

• FTC complaint alleged that the merger of Ciba-Geigy and Sandoz would result in an anticompetitive impact on innovation in gene therapies (firms’ gene therapy position so dominant that other firms doing research in this area needed to enter into JVs or contract with 1 of the 2 firms in order to commercialize their own research)

• Order required new company, Novartis, to grant to all requesters a non-exclusive license to certain patented technologies essential for development and commercialization of gene therapy products (among other conditions)
Valero/Ultramar (2001)

- The FTC approved this merger of petroleum refiners, subject to certain divestitures affecting the refining and bulk supply of CARB II and CARB III gasoline.
- The FTC alleged a CARB III product market even though CARB III specs not in effect until 2003, because it was unlikely that market concentration would change much.
  - If future market changes are fairly predictable, dynamic considerations are less important.
Coca-Cola (2010)

- *Vertical* mergers may raise issues of acquisition of confidential information that could reduce dynamic incentives to compete with rivals in the future.
- Remedies may be aimed at allowing mergers to realize vertical efficiencies while eliminating such anticompetitive possibilities (may occasionally be appropriate in *horizontal* cases as well).
- For example, in *Coca-Cola* (Sept. 2010), the FTC allowed Coca-Cola to acquire its largest North American bottler (which also distributes products of rival producer Dr Pepper), subject to its setting up a “firewall” to ensure that Coca-Cola employees did not obtain access to sensitive confidential Dr Pepper marketing information.
ENH Medical Group (2007)

• FTC ruled Evanston Northwestern’s consummated merger with Highland Park Hospital had proved anticompetitive, but adopted a behavioral remedy rather than a costly and potentially risky divestiture

• FTC required Evanston to set up 2 separate and independent contract negotiation teams to bargain with managed care organizations to revive competition between Evanston’s 2 hospitals and the Highland Park hospital
  – Dynamic remedy aimed at changing incentives
Post-2010 HMG Developments

- FTC horizontal merger settlements following release of the 2010 HMG may use behavioral remedies, when appropriate
- See, for example, *Dun & Bradstreet* (Sept. 2010) (certain D&B customers given option to terminate their contracts without penalty, employment restrictions lifted on D&B employees, D&B technical assistance for firm buying D&B assets); *Cardinal Health* (July 2011) (right of certain merged firm customers to terminate contracts without penalty, non-interference with recruitment of merged firm’s employees)
- See also 2011 DOJ Policy Guide to Merger Remedies (discussing use of behavioral remedies)
Perrigo/Paddock (July 2011)

• FTC proposed settlement agreement between 2 generic drug makers seeks to preserve actual competition in certain markets and future competition in others (focus on industry dynamics)
• Requires acquiring firm Perrigo to divest 6 drugs
• Also, to preserve future competition in testosterone gel market, Perrigo banned from accepting payments from Abbott Labs (maker of branded gel), which could incentivize Perrigo to slow entry of its generic product; and Perrigo banned from entering into “pay-for delay” agreements with Abbott
Conclusion

• Dynamic (not just static) effects are a key part of federal merger enforcement
• The 2010 HMG place greater emphasis on dynamic elements, consistent with the evolution of merger analysis
• The FTC has long taken dynamic considerations into account in its merger enforcement actions, and will continue to do so, applying new HMG tools