Discussion Points

Presented by the Business and Industry Advisory Committee (BIAC) to the
OECD Competition Committee
Working Party No. 3 on Co-operation and Enforcement

“Managing Complex Merger Cases: How Agencies Deal with Complex Data Analysis,
Surveys and Market Studies, and Obtain the Necessary Expertise for Complex Substantive
Issues (e.g. IPRs, Technology Markets, etc.)”

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I. Introduction

1. The Business and Advisory Committee (BIAC) to the OECD appreciates the opportunity to
submit these comments to the OECD Competition Committee’s Working Party No. 3 (WP3)
for its roundtable on “Managing Complex Merger Cases: How Agencies Deal with Complex
Data Analysis, Surveys and Market Studies, and Obtain the Necessary Expertise for Complex Substantive
Issues (e.g. IPRs, Technology Markets, etc.).”

II. Use of Economic Data in Complex Merger Analysis

A. Role of Economic Evidence Generally

2. The potential for economics to inform agency analysis of mergers has expanded greatly in
recent years. This progress is attributable to both an advance in the understanding of the role
of economics in merger evaluation, as well as improvement in techniques available to
evaluate potential competitive effects.

3. These advances, however, have not enabled economics to become a primary tool for merger
analysis under any scenario. The analysis of potential competitive effects requires the
consideration of a wide range of issues, including among other factors: market definition and
market structure, historical growth of the industry and its participants, cost structure of
participants, influence of technological development, pace of innovation, presence of
intellectual property rights, level of product differentiation, interactions among competitors,
the ability to gain productive and dynamic efficiencies, actual entry, potential entry, and
supply-side substitution. Even the most robust economic models cannot account for this
range of important considerations.

4. A holistic approach is not only warranted, but is the only means by which an agency can
assure itself that a correct judgment is being made about the potential effects of the
transaction. Because the cost of Type II error is significant (i.e., depriving consumers of the

* Paper prepared by John M. Taladay and Calvin S. Goldman, Q.C. with substantial contribution from BIAC
Competition Committee members.
potential synergies of a merger), enforcement decisions should not turn on a single piece of evidence or economic observation.

5. In other words, while economics at times can help to provide assurance that an analysis of the facts is accurate and can help to bolster a conclusion regarding competitive effects, economic analysis should not be used as the sole basis for concluding that a transaction will (or will not) lead to anticompetitive effects.

6. Also, economic analysis of complex mergers requires sufficient capacity and experience by an agency in order to be a useful and meaningful exercise. While we strongly support the application of economic principles to the substantive analysis of mergers by all reviewing agencies, BIAC cautions against undue reliance on economic modelling and merger simulation by agencies that lack substantial economic capacity or have limited history in conducting such analyses.

7. Rigorous factual analysis is a crucial component of merger analysis. Economic evaluation of mergers that is not grounded in sound factual analysis is without value. Parties to merger transactions at times have witnessed the advancement of an economic theory of harm that incorporates a raw misunderstanding of the facts. Often, this misunderstanding has been promoted by an opponent of the transaction (often a competitor) who may have unique motivations to see the deal collapse or who may have a different set of circumstances (e.g., different production techniques or cost structure) from the merger parties. For this reason, BIAC recommends that agencies thoroughly evaluate factual assumptions of any economic model and carefully consider the applicability of those assumptions to the merging parties. Best practice would incorporate the use of independent analysis, third-party expert consulting, physical inspection, or other means of factual verification of disputed or uncertain facts. Such measures have been adopted, for example, in several cases before the European Commission, although the practice is not uniform.\(^1\)

**B. Limitations on Use of Merger Simulation Models**

8. Enforcement history has shown that very few mergers lead to a potential for anticompetitive effects. The structural preconditions for anticompetitive effects are present in only a small fraction of notified transactions. For example, in the EC only 13 Phase II proceedings were initiated in 2006 out of 356 notifications. In the U.S., only 45 second requests were initiated out of 1,746 notifications. An even smaller number of notifications led to actual enforcement efforts. Thus, the use of detailed economic analysis normally should be reserved to that small subset of mergers that provides a structural framework that implies a presumption of anticompetitive effects.

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1. See, e.g., Comp M.4403 Thales / Finmeccanica / Alcatel Alenia Space & Telespazio at §§ 17 to 22; Comp M.3687 Johnson and Johnson / Guidant at §§ 70, 105.
9. Even within this framework, the limitations on the use of economic models should be recognized. A number of the frailties of economic analysis in general, and merger simulation models in particular, are outlined in a paper prepared by Werden, Froeb and Scheffman. Among these limitations are:

--- A scarcity of evidence verifying the accuracy of merger simulation in predicting the effects of actual mergers;

--- The critical role of the modelling process, which is described as “at least as much art as science”;

--- The potential bias resulting from the beliefs, qualitative evidence and data used in preparing the model;

--- The need for a proper “fit” between the factual setting of the industry and the structural model being employed; and

--- Modelling error stemming from inaccurate assumptions or sampling error.

10. These limitations, in large part, provide yet another reminder of the critical nature of sound factual analysis as an underpinning to the economic analysis of mergers.

11. In evaluating the role of economics in antitrust analysis, then-Director of the FTC Bureau of Competition Dr. Salinger similarly notes that economics must fulfill a dual role in case evaluation. It must simultaneously subject the theory of the case to an “economic sense screen,” while at the same time, it must avoid mistaken inferences which can be “especially costly because they chill the very conduct the antitrust laws are designed to protect.”

12. An additional limitation that should be recognised is the quality of the merging parties’ data itself. This can often be a significant impediment to producing a meaningful analysis of potential merger effects. Merging parties, who obviously have a significant interest in putting forth an affirmative economic analysis (assuming favourable results), often find that they are unable to advance such an analysis (despite favourable results) because the data is not of requisite quality. It should be remembered that the company’s purpose in maintaining the data is quite different from the economist’s purpose. Company X’s data may be maintained principally for accounting, assignment of internal accountability, management of personnel or other reasons that do not lend directly to a meaningful analysis of industry, or even Company X’s, dynamics.

13. An interesting example is provided by an actual merger among two large software manufacturers. As a means of ensuring that employees were adhering to limits on their authority, the Acquirer (like many companies) had a policy that required higher-level


--- Michael A. Salinger, *The Legacy of Matsushita: Has This Thing Called Economics Gotten Way Out of Hand?*, Loyola University School of Law Institute for Consumer Antitrust Studies (Sept. 29, 2006), at 2. Although Dr. Salinger was addressing the role of economics in civil litigation, we believe the cited principles are equally apt for merger analysis.

approval for higher-level discounts. A sales representative seeking authorisation for a discount above a certain level had to indicate the reasons for the discount (e.g., size of customer, length of maintenance agreement, etc.). One data field requested that the sales representative indicate the identity of the competitor. From information on the forms, it would be conceivable to conduct an economic study examining the degree to which the level of discount was dependant upon the identity of the competitor. It would also be conceivable to evaluate the degree to which the elimination of a competitor might impact a customer’s ability to obtain a larger discount. It might even be conceivable to control for other relevant factors such as the size of the customer, length of contract, etc.

14. Ultimately, however, the data was insufficient for meaningful analysis for two key reasons. Firstly, it became clear that the sales representatives – who were compensated by commission and whose key interest was completing a sale rather than maximising margin – were sometimes manipulating the forms in order to justify as high a discount as possible. Secondly, it also became clear that the information about the identity of the competitor was often wrong. Post-sales interviews with customers, who no longer had an incentive to hide the identity of the competitor, revealed that the Acquirer incorrectly identified its competitor in more than half of the cases. Thus, what at first appeared to be a potentially extremely meaningful database turned out to be useless. This realisation, however, occurred only as a result of thorough factual analysis.

15. Werden, et al., recommend an approach for advancing the reliability of merger simulation analysis, suggesting that “every modelling choice in a merger simulation apt to matter significantly be accompanied either by some sort of justification or by a sensitivity analysis indicating its impact.” BIAC believes that this approach is warranted in merger review given the high potential cost of unnecessary enforcement or prohibition of mergers.

16. The most common economic model used for merger simulation has been the Bertrand oligopoly model, which assumes a single competitor interaction in which each competitor maximizes its short-run profit with price as the sold dimension of competition. This model estimates a price equilibrium based on game theoretics which can then be used, in the opinion of some experts, to predict a post-merger price equilibrium based on the altered competitive landscape. The model has been used most frequently in mergers of manufacturers of competing but differentiated consumer goods. The analysis often has been supported by scanner data from retail outlets such as grocery stores.

17. Froeb and Werden differ with Scheffman regarding the ultimate utility of Bertrand modelling for merger simulation: They believe that the model can be a useful predictor of post-merger pricing, while Scheffman believes it is an inadequate model of competition due to, inter alia, its failure to consider non-price competition. However, all three agree that an economist using the Bertrand oligopoly model must also consider repositioning, entry, and retail-wholesale relationships.

18. It is clear that no economic model can adequately address all relevant components of competition. At best – when the model comprises a “fit” with the industry, avoids modelling

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5 Werden, et al., supra note 1, at 90.

error and incorporates meaningful data – merger simulation can inform the analysis of potential competitive effects by providing some indication of the potential magnitude of these effects.

19. Even in this setting, however, it must be recalled that merger simulation models are never a precise measure of merger effect and are not calibrated to evaluate small changes. Modelling error and sampling error are ever-present risks and, for that reason, “(m)erger simulation predictions are at best reasonable, but rough, estimates of the likely effects of mergers.” Because of these two sources of potential error, “price increase predictions close to zero cannot meaningfully be distinguished from zero.”

C. Judicial Review of Economics in Merger Analysis

20. Economic analysis has become increasingly prominent in the judicial review of agency decisions regarding merger enforcement.

21. The European Court of Justice has closely scrutinised the application of economic principles to merger review. It has held that: “Whilst the Court recognises that the Commission has a margin of discretion with regard to economic matters, that does not mean that the Community Courts must refrain from reviewing the Commission’s interpretation of information of an economic nature. Not only must the Community Courts, inter alia, establish whether the evidence relied on is factually accurate, reliable and consistent but also whether that evidence contains all the information which must be taken into account in order to assess a complex analysis and whether it is capable of substantiating the conclusions drawn from it”

22. The European courts have also recognised the difficult challenge created by the need of the Commission to rely, at least to an extent, on the information provided by the merging parties and third parties. At the same time, the ultimate responsibility for ensuring the reliability of data is the Commission’s. “Although, as the Commission stated at the hearing, the procedure for the control of concentrations does indeed rely to a large extent on trust, as the Commission cannot be required to ascertain on its own, in the slightest detail, the reliability and accuracy of all the information submitted to it, it cannot, on the other hand, go so far as to delegate, without supervision, responsibility for conducting certain parts of the investigation to the parties to the concentration, in particular where, as in the present case, those aspects constitute the crucial element on which the decision is based and where the data and assessments submitted by the parties to the concentration are diametrically opposite to the information gathered by the Commission during its investigation and also to the conclusions which it drew from that information.”

23. Recently, in FTC v. Whole Foods, the U.S. Federal District Court for the District of Columbia evaluated the economic testimony of expert witnesses proffered both by the

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7 Werden, et al., supra note 1, at 90. (Emphasis in original.)
8 Id.
9 Case C-12/03 P, Commission v Tetra Laval, judgment of 15 February 2005, at § 39.
defendants and the FTC. First, the judge evaluated the testimony of an expert in consumer polling, Ms. Conway, who had conducted a consumer survey to support the defendants’ market definition arguments. An FTC expert, Dr. Van Liere, attacked the survey methodology and procedures as fundamentally flawed. The Court agreed with Dr. Van Liere and disregarded the evidence produced by Ms. Conway.

24. At the same time, the Court evaluated the competing testimony of Dr. Scheffman (on behalf of the parties) and Dr. Murphy, two leading economists, with respect to the determinative issue of market definition. Dr. Murphy’s analysis was based on a “natural experiment” and estimated the effect of competition between the merging parties (Whole Foods and Wild Oats) observed from the entry of Whole Foods in markets where Wild Oats was already operating. Ultimately, the court accepted Dr. Murphy’s testimony (i.e., the court did not conclude that the analysis was unfounded as it had with Ms. Conway’s testimony), but found it unpersuasive because the analysis:

-- Evaluated the impact on Wild Oats margins rather than prices;
-- Did not include the price and promotional strategies of competitors outside the FTC’s asserted relevant market;
-- Failed to consider the effect of market exit, which the court considered a more relevant metric of potential effect than entry;
-- Failed to account for non-price promotional strategies; and
-- Contained an inadequate number of observations to be reliable.

25. The Whole Foods case provides an illustration of the potential pitfalls of economic modelling as a means of estimating the potential anticompetitive effects of mergers. While the study may have been a useful tool for helping the agency to confirm its impressions about competition between the parties under one particular scenario (i.e., within a market purposefully limited to Premium Natural and Organic Supermarkets), it was deemed insufficient as a basis for evaluating net competitive effects.

26. On the whole, the EC and U.S. judicial analysis of merger cases have relied heavily on economic analysis, particularly in recent years. The courts have held the agencies to a high standard in considering the economic basis on which the outcome was determined. These decisions highlight the need for careful application of economic analysis and the need to avoid overreaching (both by the parties and by the agencies) in applying economic modelling to merger decisions.

27. Under the Canadian Competition Act, the use of economic data in complex merger cases is very similar to that which takes place in the U.S. and EC, particularly in relation to issues such as relative market analysis, other qualitative considerations and market power and ultimately the threshold of market power. In addition, section 96 of the Competition Act provides for a statutory efficiency defence which received adjudicative interpretation and application in the Superior Propane\textsuperscript{12} case. In that case, which was initially decided in 2001

(following a contested hearing which lasted for months), the Competition Tribunal found that the merger was likely to lead to a substantial prevention and lessening of competition (an "SPLC"), but applied an efficiency defence balancing exercise and found that likely gains in efficiency were greater than and offset the likely anti-competitive effects. The merger was allowed to proceed on that basis.

28. The then Commissioner appealed that decision to the Federal Court of Appeal, which overturned the Tribunal decision on the grounds that the Tribunal did not correctly account for all of the effects of the merger (specifically the impact of higher prices paid by those consumers who continued to use propane post-merger - also known as the "wealth transfer" from consumers to producers) and the case was sent back to the Tribunal.

29. The Tribunal, in its redetermination decision, cleared the merger again, this time adopting the "balancing weights" approach. The Commissioner at that time appealed again, but in 2003 the Court of Appeal dismissed the appeal and upheld the Tribunal's decision, endorsing the balancing weights approach. The Court of Appeal noted that this approach differed from the total surplus standard, and more specifically upheld the Tribunal's position that only the socially adverse portion of the wealth transfer plus the dead weight loss should count against the efficiency gains. In that particular case, the efficiency gains that were proved were about three times larger. Needless to say, complex financial, economic and expert evidence were provided and referenced throughout this lengthy process.

30. While consideration was given to the current Canadian standard in a consultative process that took place after the Superior Propane decision (which was initiated by Commissioner Sheridan Scott) there has been significant clarification of the Canadian position following the address given by Commissioner Scott on September 28, 2006 when she stated the following:

"While we will continue our work on efficiencies, and anticipate being able to provide greater guidance in the near future on what we consider to be the appropriate enforcement approach, I would like to share with you certain observations and principles arising from the work conducted to date.

First, we do not consider that, in the short term, it is either desirable or advisable to seek amendments relating to efficiencies. While we believe that there remain areas of uncertainty with respect to the enforcement of the efficiencies defence, we will, at this stage, devote our attention to clarifying how we interpret our mandate, in view of the current statutory language and such case law as we have, and how we will pursue that mandate in practice.

Second, we want to emphasize, as we make explicit in our Merger Enforcement Guidelines, that we do consider efficiencies claims when submitted. Robust and thoughtful submissions are important to us, offering insight into both the parties' motivation for the transaction as well as the potential synergies relevant to our assessment. We would urge your clients to bring those submissions to us early in as substantiated a form as possible, and not to be deterred by an unfounded notion that to do so is somehow an admission of anti-competitive concern.
Third, a clear reading of the Act requires that we consider efficiencies in the course of our assessment as to whether to challenge a merger. As to section 96 specifically, we would not necessarily require recourse to the Tribunal in a case where the efficiencies resulting from the merger would clearly be greater than and offset any anti-competitive effects; rather, while our experience suggests that such cases are rare, we could, if sufficiently satisfied on the evidence, make our own independent assessment of efficiencies, and clear the merger on that basis.¹³

31. Thus in Canada, the economic analysis of efficiencies is a particularly important component of merger review and in the right case, may lead to clearance of a proposed merger without contested proceedings before the Competition Tribunal. Indeed, successful proof of an efficiency defence will necessitate a combination of solid financial data supporting the various categories of production, distribution, overhead and other efficiencies, which is then supported by expert economic evidence. In addition, dynamic efficiencies are increasingly being considered and applied in proper cases in Canadian merger analysis.¹⁴ In the right Canadian case, sufficient financial and economic data may avoid a "battle of experts" before the Tribunal. It is important, however, to emphasize that the economic analysis done in Canadian cases (by both the Bureau and the private sector) must be based upon a concrete factual foundation; economic modelling and conclusions which are not properly based on solid factual foundations will inevitably be shown to be less credible in this process. Therefore, even in complex Canadian efficiency cases, economic experts and the evidence presented by them must be properly grounded on the relevant facts.

III. Conclusion

32. Economic analysis is an indispensable tool in merger evaluation, but effective economic analysis does not imply that complex merger simulation exercises, consumer surveys, demand elasticity measurements or other economic gymnastics need be adopted in order to gain assurance of an accurate enforcement decision. Indeed, over-reliance on such measures, particularly for agencies without substantial capacity and experience, can create a risk that inaccurate enforcement decisions will be made. While BIAC applauds the introduction of economic thought into merger analysis by numerous agencies in the past decade, it also suggests that agencies firmly establish their footing in factual evaluation in an economic construct before undertaking more complex economic analyses.

¹³ Speaking notes for Sheridan Scott, Commissioner of Competition Bureau, Canada, delivered to the Canadian Bar Association Annual Fall Conference on Competition Law, September 28, 2006.