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A ROUNDTABLE SPONSORED BY THE BUREAU OF ECONOMICS
UNDERSTANDING MERGERS:
STRATEGY & PLANNING, IMPLEMENTATION AND OUTCOMES

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FEDERAL TRADE COMMISSION

<u>I N D E X</u>

(PANEL 4 EXCERPT)

<u>Edited Transcripts:</u> These proceedings were professionally transcribed as described on page 365 of the transcript. The transcript was edited by FTC staff to improve punctuation, spelling and clarity. In addition each speaker was given the opportunity to edit his/her comments.

Tuesday, December 10, 2002

UNIDENTIFIED MALE: Absolutely.

MR. BRODSKY: It's not just the employees that get solicited, it's the customers, because it's a period of uncertainty, and especially for the acquired company, their constituencies don't know what's going to happen to the company. In that uncertainty, there's more of a propensity to change.

MR. BOWER: There's also an issue which Dan Scheinman picked up. Sometimes when you're adding products to fill into a line, what you're doing is you're dealing with a problem that the product division or the sales organization had created for you. And then you put that new product line in an organization which is fundamentally hostile to it or doesn't have the capabilities to sell it or doesn't understand it, or you get into a fight and then you lose your revenue projection for that kind of reason.

Any more other questions?

(No response.)

MR. BOWER: Well, then, I'm going to thank the panel. I've heard a number of comments from the audience and also some of the people who left. They were apologizing and said, "this is just fantastic,". We really thank you.

PANEL 4
HOW AND IN WHAT CONTEXT DO COST SAVINGS OF VARIOUS KINDS AFFECT BUSINESS DECISION MAKING? WHAT HAVE BEEN THE FTC AND DOJ'S EXPERIENCES WITH EFFICIENCY CLAIMS?

MR. SCHEFFMAN: All right, welcome back to the ice box. It's a little warmer today, isn't it?

GROUP: Yes, it is.

MR. SCHEFFMAN: Well, they will probably fix that, so don't leave your coat, all right? We're delighted you came back after yesterday's very interesting session.

Today we're getting back more explicitly into antitrust land. The first panel today deals with an issue that economists have known about for decades, in fact forever, which is that actual business decisions are often made in part based on average costs rather than incremental costs. That's been a matter of some concern to economists for years. At various points, economists have done surveys of businesses, where they’ve asked, what's the most important determinant of prices? And the response has been, average costs. Which is an embarrassment to economists, but I think it's because economists haven't really thought about what the role of costs are in business decision-making.

So, what we want to do today in this first session is have someone put forward arguments about why businesses use something other than incremental costs in decision-making. The person that's going to do that is David Painter. For those of you not from the Commission, David Painter was at the Commission for 25 years. He was our lead financial analyst. He was the internal person who actually assessed efficiency claims made by parties, and now he does a lot of work on the outside as a consultant putting forward efficiency arguments, so he has an interesting background in that regard.

The chair of the panel today is Andrew Dick, who's Acting Chief at our sister agency, the Department of Justice, Antitrust Division. Andrew will not just be a moderator but will be talking a little bit about the second topic of today's session. The other member of the panel is Gabe Dagen, who currently is the head of our financial analysts. The financial analysts at the FTC have a very important role, such an important role that I stole them back from the Bureau of Competition in the last year. Were you ever in the Bureau of Economics, David?

MR. PAINTER: Not as part of the competition part of it. I was with the old line of business program.

MR. SCHEFFMAN: Okay. Well, I think at some point, many years ago certainly, when the Commission started, I think there were financial analysts in what today would be called the Bureau of Economics. At some point the lawyers stole the financial analysts, and in the last year I stole them back where they belong, with the other quantitative geeks. The purpose of that was to really re-invigorate and enlarge the role of financial analysis in our merger investigations, and antitrust investigations generally. I'm a strong believer, as a long-time MBA professor, that financial analysis is very important, and we do much more financial analysis than we used to in the investigation of cases.

Gabe Dagen is the leader of a group of five financial analysts that we have. We have hired several within the last year, and they are all busy doing lots of useful things. So, Gabe will provide some comments on David's presentation on costs, how costs may affect business conduct in various situations. Gabe will provide a reaction in part from the point of view of how we as enforcers can or should take such arguments into account in our analysis of potential efficiencies.

Then Gabe and Andrew are going to talk about our so-called chicken and egg problem, to come back to Chairman Muris' comments of yesterday. That is, we actually are prepared to assess efficiencies, but we don't actually see substantial credible efficiency claims generally. There seems to be a problem that the private bar advises their clients that it isn't worth it, and as the Chairman indicated, that's not true. As he also indicated, in the majority of the cases, it's probably not worth it, but in some cases it is, and we're not seeing it. So, Gabe and Andrew are going to speak a little bit from the point of view of the two agencies, about what we see and what we don't see in terms of efficiencies analyses.

So, I'll turn it over to you, Andrew. Thank you.

MR. DICK: I should start with a disclaimer, and Gabe asked me to include him in this disclaimer. I'm not going to be speaking as a representative of the Department of Justice, and Gabe won't be speaking as a representative of the FTC or its Commissioners.

As David indicated, there are two questions, and they are going to seem distinct, but hopefully as we get into the discussions, we'll see how they relate to one another..

The first question, which David Painter will speak to presently, is how and in what context do cost savings of various kinds affect business decision-making? The second question that the panel will discuss is what has been the experience of the agencies and private parties in presenting and evaluating efficiency claims? What do the agencies usually receive from merging parties by way of efficiency arguments and supporting evidence, and equally importantly, what should parties provide to make their arguments and evidence as compelling as possible?

David previously introduced the two panelists, but let me just add one or two more words about them. David Painter is a Director at the Law and Economics Consulting Group (LECG). He specializes in antitrust, finance and damage estimation. Formerly, he was the Chief Accountant at the FTC where he had responsibilities for accounting and financial issues in a wide range of merger and non-merger investigations.

To his right is Gabe Dagen, who is the Assistant Director of the Accounting and Financial Analyst group at the FTC. Gabe has been with the FTC for four years and has performed efficiency, valuation, and viability analyses in a wide range of investigations.

And as David mentioned, I'm the Acting Chief of the Competition Policy section at the Department of Justice. I'm also an economist, and so hopefully, among the three of us, we'll bring some perspective from a number of different experiences.

I'm going to ask David to begin. Again, his topic is how and in what context do different types of cost savings affect decision-making by businesses?

MR. PAINTER: I appreciate the opportunity to be here. It's good to see old faces and it's good to see new faces here. I wanted to carve out sort of a narrow aspect of efficiencies. It's narrow in the sense that it's a discrete area, it's not narrow, however, in terms of its importance. I'm going to address the importance, as I see it, of fixed cost savings in antitrust efficiency analyses. I'm not going to be touching on variable cost savings. I think everybody acknowledges and the Guidelines speak fairly clearly to the importance of variable cost savings and the potential for those savings to have a direct impact on prices. But I think that fixed cost savings may present some of the very same benefits that variable cost savings present and maybe more, so that's going to be the area of my focus.

I've been asked to speak about the potential consumer benefits that fixed cost savings from a merger might create or might contribute to. It is an area, I think, that merits greater attention and credit by the antitrust agencies. More and more, I confront experienced antitrust counsel, and antitrust consultants who are very reluctant to assert fixed cost savings as an efficiency of the proposed merger based on the advice of antitrust counsel and consultants. I am not one of those consultants who shares this view. The merging parties are frequently unwilling to bear the cost required to properly identify, substantiate and measure cognizable fixed cost savings of the merger. Why is this the case?

It's largely because many antitrust practitioners perceive that fixed cost savings will be accorded little or no credit in the antitrust assessment of the merger, and worse, will be used more as evidence against the merger than as a pro-competitive benefit in the Government's evaluation. In their experience, fixed cost savings have been acknowledged by the antitrust authorities only to demonstrate the existence of high entry barriers and not consumer benefits.

As David pointed out, however, I think, in recent months and maybe the recent year, antitrust enforcement officials have gone to great lengths to re-affirm that fixed cost savings, and indeed all efficiencies, are acknowledged as potential consumer benefits under the DOJ/FTC Horizontal Merger Guidelines, and are going to be given much more credit and attention by the authorities.

With that said, that is the reason why I'm here, to sort of speak to the potential benefits of fixed cost savings.

As seen on the slide at the bottom of the first page of my handout, I want to make four points today. First, I want to make it clear that the Merger Guidelines do acknowledge the potential importance of fixed cost savings as consumer benefits. The second point I want to make is that fixed cost savings can provide direct price-related consumer benefits. Third, fixed cost savings can contribute to important non-price consumer benefits. And fourth, it is my opinion that the importance of fixed cost savings needs to be assessed on a case-by-case basis. That is somewhat dissimilar to variable cost savings, which, I think, almost across the board one would acknowledge are going to have the potential to reduce prices.

First, how do the Merger Guidelines acknowledge the importance of fixed cost savings? As shown in the slide on the top of p. 2 of my handout, they do so by identifying a variety of consumer benefits that could potentially arise from merger or acquisition. One, lower prices, first and foremost. There's no question that the FTC and DOJ prefer merger benefits in the form of price reductions. That preference is understandable to me and to others, in that efficiencies become less certain, both in terms of their achievability and their merger specificity, and are less able to offset the more immediate potential competitive harm, the more distant their realization is into the future.

Nonetheless, the Merger Guidelines do point out the potential for benefits even when price is not immediately and directly affected, and some of these areas actually fall into the fixed cost savings consumer benefit area. Mergers may lead to new and improved products, enhanced service, increased output and may change for the better the incentives of companies to compete. And with respect to all of these non-price consumer benefits, fixed cost savings can contribute to the financial and economic justification of them, as well as serve as a ready source of capital for the funding of these investments.

First, let me talk about price-related consumer benefits. Fixed cost savings clearly have the potential to provide direct consumer price benefits. In many circumstances, as David Scheffman pointed out, fixed costs figure directly into pricing policies, methodologies and practices. I want to point you to an article that was published in the 1997 Journal of Management Accounting Research, it was called "The Full Cost Price and the Illusion of Satisficing." I actually sent in a variety of studies attached to a bullet point presentation that, I think, may be available as part of handouts, but this is one of those studies.

In any case, this study refers to two previous studies of corporate pricing practices, both of which concluded that fixed costs are taken into account far more often than not in setting prices. Let me identify the specific studies, which are referenced in the slide on the bottom of p.2 of my handout. One of them is Govindarajan and Anthony, titled "How Firms Use Cost Data in Price Decisions." This was published in July of 1983 in the Journal of Management Accounting. The other is Shim and Sudit, "How Manufacturers Price Products," published in 1995.

The first study, a 1983 survey of the pricing practices of the Fortune 1000 industrial companies, made a number of startling conclusions at the time, as shown in the slide on the top of p. 3 of my handout. It found that 41 percent of the 501 responding companies -- 501 out of the 1000 surveyed, a very high response rate -- based their prices on total costs, that is, both fixed and variable production and non-production costs. Another 41 percent based prices on total production costs, which contains an element of fixed costs, fixed overhead, plus some variable non-manufacturing costs. Only 17 percent actually used variable cost pricing.

The reasons cited generally for deviating in actual practice from profit-maximizing pricing models included the lack of time, the lack of resources and very much the lack of information that was needed by managers in order to set the optimum pricing model. The authors of this 1983 study concluded three points. Two of them are quoted in the slide on the bottom of p. 3 of my handout.

First, “in the real world, most large companies use full costs rather than variable costs” in their pricing decisions. Second, the results of the survey -- and this is a quote -- "unequivocally destroy [...] the myth that full costs, and especially allocated costs, are irrelevant as a basis for pricing decisions." The third point was that the apparent conflict between actual pricing practice and economic pricing theory was a sign, in the view of the authors, that something was wrong with the theory.

As seen in the slide on the top of p. 4 of my handout, the more recent 1995 study, surveyed 600 large industrial companies. That survey found that 70 percent of large manufacturing companies set prices by marking up some version of full costs; that is, a combination of fixed and variable costs. When I say fixed and variable costs, I'm also including allocated costs. Only 12 percent of the 141 respondents to this survey reported using a form of variable cost pricing, and only 18 percent professed to set prices based upon market conditions or competitive conditions.

The studies were 12 years apart, but the conclusions of the studies are very consistent with one another. Both studies acknowledge that, as we all know, there may be instances where it makes good business sense to take orders at less than normal prices, as well as situations that permit you to take orders at much higher than normal prices. But these were considered in both studies to be departures from the normal situation of pricing to cover all costs and to earn a satisfactory return on investment. Also, both the studies suggested an apparent conflict between economic theory and actual practice in setting prices.

These are just illustrative examples supporting the proposition that fixed cost savings have the potential to directly lower prices, and certainly not exhaustive of such situations. As shown in the slide on the bottom of p. 4 of my handout, there are numerous other examples of instances in which fixed cost savings can lead to lower prices. For example, pricing may be tied to cost-based contracts and contracts that allow for cost audits, and either of these kinds of contracts could cause prices to be reduced if fixed costs are reduced.

Also, there are many firms that submit bid proposals that reflect on a line-by-line basis a variety of costs and expenses, many of which are fixed, and in these instances obviously reducing fixed costs could affect the bids. There's also a very common situation that I've seen employed on the outside, in terms of setting prices for simplicity sake, which is where the pricing decision is tied to a specific gross profit threshold. That is, we'll take on this business and we'll price it in such a way that we have to earn at least 20 percent gross profit. And the reason for employing a gross profit threshold for setting prices is that the firm needs to cover other costs and expenses that may not be built directly into the pricing model, a lot of those costs and expenses being fixed or allocated costs. Obviously, as one is able to reduce some of that group of costs, then it may well be that pricing can be tied to a lower threshold.

There are other situations such as where power buyers or very knowledgeable buyers will learn fixed cost reductions that their suppliers are realizing, either through merger or on a stand-alone basis, and they can, based on that knowledge, perhaps force a lower price.

I want to also bring up one other situation, referred in the slide on the top of p. 5 of my handout. I will admit that it's speculative, and I haven't found empirical studies that sort of go to it. But, I think, fixed cost savings have the potential to provide management, particularly management of public companies, the latitude to undertake price-cutting that have short-term earnings consequences but offer the potential for long-term growth and long-term earnings enhancement. Public companies are under close scrutiny on a day-to-day basis and week-to-week basis, and short-term earnings is something that oftentimes is the primary focus of management.

With respect to these companies, variable cost savings and fixed cost savings have equal footing. They both contribute to profits equally. And to the extent that fixed cost savings that might be achievable through a merger can somehow help satisfy stockholder expectations or market expectations, it may provide the comfort level to management to undertake price cutting and a variety of things that may have some adverse consequences in the short term but positive benefits in the long term.

The slide on the bottom of p. 5 of my handout identifies another area where fixed cost savings can have a very positive effect on prices, and it's a very common area, I think. There are situations where managers, people that are actually responsible for setting prices, are held accountable for obtaining a target level of profitability that includes or reflects both fixed and allocated costs. Brand managers, product managers are often a part of this management group. They typically operate their businesses as a profit center, as contrasted, for example, to maybe a manufacturing operation, which is typically treated as a cost center. They often will not have knowledge of the breakdown between fixed and variable costs. They may be dealing with costs that are imposed on them in terms of marketing costs, R&D costs, allocated corporate overhead costs and so forth, and they are held accountable to make sure that their products and brands earn a profit to cover those costs.

Typically the costs that they are held accountable for would include, for example, an allocation of corporate charges for services and functions that are performed at the corporate level on behalf of not only their product area but a variety of other business areas. Obviously, as one is able to reduce the group of costs that typically gets allocated back to product managers and brand managers, then one might be able to see the beneficial effect on pricing of having a reduction in the fixed costs comprising that group of allocated costs.

I just want to remind you again of one of the studies that I referred to earlier. The study concludes, and, I think, it's consistent with brand managers and a variety of other managers that are responsible for the businesses that they supervise, that people often lack the time, they lack the resources, and more importantly, they lack the information particularly on demand side kinds of things that will allow them to really set optimal price. They know that they're going to be evaluated based upon the target profits that are imposed on them, the P&Ls that are imposed on them, the pro formas that are imposed on them, and for that sake and for other reasons, they, in setting prices, will often take account of fixed costs and allocated costs.

Even managers that have access to the breakdown between fixed and variable costs in my experience don't necessarily use them in the calculations of what prices to set. Many companies keep their books and records in a way that balances off the trade-off of the cost associated with fine tuning your costs -- determining exactly how much is fixed and how much is variable over various ranges of output -- with making it workable, making the accounting system workable for the people that need to work with it. For that reason, the definitions of fixed and variable often are not precise within the books and records of a company, and the company's managers acknowledge that and are aware of that.

Another situation where fixed cost savings can lead to lower prices is in transfer pricing; that is, transfers between business units of a corporation, goods and services that are being provided from one unit to another. These transactions will usually lack the arm's length bargaining and the influence of market forces as a basis for what the pricing will be. The ability of a merger, for example, to reduce the fixed costs of one of the business units that's transferring some good or service to another unit can well affect the transfer price and ultimately the final price of the finished product.

Let's move on. I wanted to put together what I thought to be a typical brand manager P&L to further emphasize some of the points that I've already made. The slide on the top of p. 6 of my handout is intended to be such a typical P&L. You can see that various line items are reflected which include fixed or allocated costs, and any of these particular costs could potentially be reduced through fixed cost savings.

For example, one line item is fixed manufacturing costs, which generally are taken into account in a brand manager's P&L. If the product obviously shares manufacturing operations with other products, this overhead component is an allocation to the brand manager.

Marketing and R&D costs are also areas of responsibility for the brand manager, and these are typically fixed in nature. Reductions in these costs, for example, through mass media efficiencies or infrastructure cost reductions that are possible through a merger could reduce the amount that gets charged or allocated back to the brand manager and may affect the price which the brand manager sets for the product.

I want to use this opportunity actually to refer to something that I'm going to discuss in more detail in just a few minutes, and that is new product development and the importance that fixed cost savings potentially can have on new product development. The pro formas that are prepared for new products often will contain some of these same cost elements in the brand manager’s P&L, including, for example, allocated costs, marketing expenses and research and development expenses. A variety of these and other costs are fixed, and, obviously, to the extent that fixed costs or infrastructure costs can be reduced as a result of a merger, it may well impact the pro forma P&L for which the product manager is responsible, as well as the financial viability, the financial justification of undertaking new product development.

And for this, I just want to refer you to a well-known text, Cotler's text, Marketing Management Analysis: Planning, Implementation and Control. In one of the chapters dealing with new product development, a pro forma P&L is presented, and it includes both fixed and allocated costs that must be covered by sales of the proposed new product. To that end, fixed cost savings might reduce some of the pro forma costs that must be covered by the new product.

I want to point out another area that can benefit from fixed cost savings, because we see it so often. I saw it very often at the Commission and on the outside I see it often. Companies engage in price wars that frequently result in competitive pricing which falls below average total cost. In instances like this, reductions in fixed costs can potentially affect the duration of below-cost pricing and also affect other consumer benefits, as shown in the slide on the bottom of p. 6 of my handout. We all know that firms have to cover all of their costs in the longer term, and the lower the fixed costs that the company has, there may well be a correlation between how long it's able to sustain or willing to sustain below full cost pricing in such a competitive environment.

There are also studies that support my next point in the slide at the bottom of p. 6 of my handout. Fixed cost savings may well enable a firm that's engaged in intensive below cost pricing to maintain non-price consumer benefits, such as R&D, new product development, product improvements, customer-oriented services, and a variety of other such consumer benefits. Commentators have noted that firms that face aggressive pricing from their rivals over extended periods often will adjust to the new profit level or loss level through non-price responses, such as reducing

R&D, advertising, customer service and product variety.

For this I refer you to another study, Goodlock and Guiltinon, and it's called "A Marketing Perspective on Predatory Pricing." It was published in the Antitrust Bulletin, fall-winter of '98. This study amplifies the consumer loss that possibly would result from this. It concludes that a loss in such non-price competitive efforts by competitors actually reduces pressure on the price leader to maintain below-cost prices or to continue to offer those same non-price consumer benefits, thereby compounding the consumer loss.

The study also concludes that at least some firms that have pared costs in this manner to remain in the market become unlikely to be aggressive competitors on either a price or a non-price basis in the future. Finally, the study concludes that extended pricing below average total cost may then lead firms to retreat to the most profitable channels and distribution areas that they service.

I've actually been involved fairly recently in a merger in which one of the merging parties had already started eliminating the least profitable customer accounts and the least profitable products, in an effort to try to remain profitable or viable in the face of a fairly prolonged price war. Obviously, to the extent that you achieve fixed cost savings, there may be products that then can continue to be maintained and customers that might continue to be serviced, resulting in greater product and supplier choice for customers.

Let me just summarize some of these remaining points on price-related consumer benefits quickly and move on to non-price consumer benefits that can result from fixed cost savings. For the same reasons fixed cost savings can help extend or intensify price and non-price competition during a period of below-cost pricing, it may also delay or reduce the risk of exit by competitors during those periods. As shown in the slide on the top of p. 7 of my handout, the result of many price wars is a relegation of losers to niche markets or an exit entirely from the market. Again, the prior study I mentioned confirms this happening, although, I think, we can observe this virtually every day if we read the newspaper, the Wall Street Journal in today's market economy. That's the Goodlock and Guiltinon study.

Let me make one last point on this. Fixed cost savings can also intensify below-cost pricing. Dell has continually touted that it has a cost structure that's half that of Hewlett-Packard as a percentage of revenues. Clearly, you know, we get the benefit of some tremendous pricing in the personal computer area. Nonetheless, Dell makes very large profits. If Hewlett-Packard and any of the other computer manufacturers were able to reduce their fixed cost infrastructure, to a level that more approximated that of Dell, you might see even lower prices.

Similarly, Delta -- we can see it with United as well -- has publicly announced that it isn't able to compete against Southwest on price because of its very high fixed cost infrastructure. It has recently announced that it's going to consider starting up another airline, a completely new airline, that could then establish a very low-cost infrastructure enabling it to compete more effectively with Southwest. But the point is that if Delta were able to reduce in a significant way its own fixed cost infrastructure, that might, again, be the basis for being able to offer lower prices on its own.

The last point I want to make on this, and then I am going to truly leave it for the non-price consumer benefits, is that incremental investments can be made possible by fixed cost savings. The cost of capital can be reduced, hurdle rates can be reduced, and, as shown in the slide on the top of p. 7 of my handout, incremental investments made possible by lower cost of capital and lower hurdle rates can, in and of themselves, lead to lower variable costs. And those lower variable costs in turn, can, as we all know, lead to lower prices.

Lastly, make/buy decisions can be enhanced by fixed cost savings. You can convert something that's being out-sourced into something whose production is brought in-house. That alone changes the cost structure for the firm from one that is generally 100 percent variable cost, the out-sourcing, to one that's a combination of fixed and variable costs, again leading to the possibility that maybe they could take that into account in pricing.

Okay, we're on to non-price consumer benefits. Let me start first by addressing what I think is a misconception held by many government antitrust enforcers. I have been confronted with this in presenting merger cases, but I admit that I probably was guilty of it myself when I was at the Commission. It is the perception that fixed cost savings benefit shareholders exclusively. It's erroneous, and let me refer you to the slide on the bottom of p. 7 of my handout. The fact is that the profit rationale behind most mergers is not to retain all fixed cost savings in order to distribute them as dividends, but rather, to maximize firm and shareholder value by investing these savings further in the business. As you know, fixed cost savings contribute to added cash flow and thus contribute to the level of investment made in the business.

There are numerous studies that show this to be the case. Dividend rates as well as the percentage of firms that are paying dividends have declined substantially over the last five to ten years, even as earnings have gone up, as shown in the slide on the top of p. 8 of my handout. For example, dividend yields have fallen from 5 to 6 percent in the mid-1970s to just a little over 1 percent in 2001. The dividend payout of earnings has fallen from 60 to 70 percent in 1991 to less than 40 percent in 2001. And this trend is true whether one uses 2000 as the cut-off or extends it into 2002 during the period where the economy has not performed well.

Similarly, the proportion of firms that pay cash dividends has fallen from 66 percent to 21 percent, roughly, from 1978 to 1999.

Importantly, also, I want to point out that studies actually indicate that the propensity to pay dividends has declined for firms with actual and anticipated high investment outlays. There's an inverse relationship between dividend ratios and expected investment outlays, as indicated in the slide at the bottom of p. 8 of my handout.

Okay, now let's talk about some of the specific non-price consumer benefits made possible or enhanced by fixed cost savings. Non-price consumer benefits flow from reduced financial leverage, as shown in the slide on the top of p. 9 of my handout. There are a lot of highly leveraged firms in the economy. Fixed cost savings can enable a highly leveraged firm to reduce its debt levels. As we all know, debt levels establish cash flow requirements and restrictions that in turn limit the amount of cash that can be invested in the business. High leverage limits marginal investments, those that approximate the company's cost of capital, and often can limit quite profitable investments, those that could substantially exceed the company's cost of capital.

Fixed cost savings can represent additional cash flow for use in reducing existing debt levels, or additional cash flow that can serve as a cushion against very restrictive financial covenants in these debt facilities, either of which can enable a firm to undertake investments that it otherwise would not be able to undertake. This is not simply speculation. Fairly recently, I worked on a merger between AmeriSource and Bergen in which one of those two companies faced this very dilemma. The Commission ultimately decided to allow that merger to proceed, and one of the reasons, I'm certain, was that that merger was going to lead to substantial fixed cost savings that a lot of evidence showed would lead to improved financial leverage, lower cost of capital and greater investment in the business.

I won't go over all of the items listed in the slide on the bottom of p. 9 of my handout, except to say that SEC filings routinely point out the types of operating limitations that are imposed by high leverage.

Finally, as I have said, fixed cost savings from a merger can lead to a lower cost of capital for the merged firm over the pre-merger levels of the combining firms. As we know, credit ratings are driven by forecasts of cash flows and the related ability of the firm to meet financial commitments and to grow the business. The expectation that the merger will enable the merged firm to achieve greater cash flow due to fixed cost savings can well affect the credit rating of the merged firm and allow it to borrow at lower interest rates, as shown in the slide on the top of p. 10 of my handout.

Chairman Muris of the Federal Trade Commission and others acknowledge the importance of capital savings efficiencies, citing empirical studies that show that large firms of a billion dollars or more enjoy borrowing rates 6 percent lower than firms of $200 million or so (e.g., about 7.0% versus 7.5%). And the courts have also acknowledged the benefits to competition and to consumers of capital savings efficiencies. This is just one that I'm citing, but International Harvester found that the acquired firm was at a competitive disadvantage because its financial condition forced it to pay more for capital, and it held that the merger would lead to a capital efficiency because it would improve the acquired firm’s cost of capital.

Finally, as shown in the slide on the bottom of p. 10 of my handout, fixed cost savings can provide an internal source of readily accessible capital. Funds generated from internal operations are the primary source of capital for funding the day-to-day operations of the business. There are transaction costs and often very long lead times associated with obtaining capital through external sources, such as debt and equity, and often this will make internal capital a preferred source of funding.

Because internally generated funds are readily available, fixed cost savings may allow funding of consumer benefits to take place more quickly. In any event, I think it's important to point out that fixed cost savings can help establish an adequate profit and cash flow from operations, which can serve as the basis for being able to obtain external capital.

Let me move on to one of the more important non-price consumer benefits that can flow out of or be enhanced by fixed cost savings. It's in the new product development area, referred to in the slide on the top of p. 11 of my handout. There are so many industries now that are driven by new product development, the food industry, consumer electronics, and so many others. As a consequence, every industry has effectively been required to come up with new product introductions much more frequently than they had historically. Product life cycles are getting so much shorter.

As I mentioned earlier, the decision to undertake new product development has associated with it a set of pro forma financial and operating statements projected three, four, five years out, which effectively show what the likely return is going to be by undertaking the new product development. Often these pro formas will contain items that represent fixed costs or that represent allocated costs from outside the actual business unit responsible for the new product development. The ability to achieve fixed cost reductions can help enhance the pro forma financial statements and the investment decision to undertake this new product development.

I think that so much of this is intuitive or obvious. For the sake of time, I'm going to skip over some of these points on new product development. I think the most important point is to know that fixed cost savings can enhance the ability and the willingness of a company to undertake new product development.

The next slide on the bottom of p. 11 of my handout identifies a variety of industries, but certainly is not an exhaustive list, where new product development has become critically important.

Bill McLeod made a presentation to the Commission as part of the global hearings that were held at the Commission four, five, six years ago. He was representing a food manufacturer, and he gave some astounding statistics with respect to the food manufacturing industry as to how many products that were on the shelves had been developed in the prior three to five years. My recollection is that 50 percent or more of all the revenues of a variety of different food manufacturers were represented by new products. So again, new product development is quite important to competition and to the competitive viability of a firm.

There also have been studies that have established a correlation between firms in these and other similar industries and the need to invest proportionally higher sums in R&D each year. Again, fixed cost savings can contribute needed funds as well as help justify the investment in new product development.

Fixed cost savings can certainly help improve the success rate for new products. I'm going to skip over the slide on the top of p. 12 of my handout, which addresses that. Instead, moving to the slide on the bottom of p. 12 of my handout, fixed cost savings can help bring new products to market quicker. That is becoming critically important, because the window of opportunity for recouping the investment in new product development is becoming shorter and shorter as product life cycles are becoming shorter. So, the justification for new product development is becoming that much more difficult.

There are studies that point out that where new products are becoming more and more important, companies are investing proportionally larger sums. Let me just refer you to one of them. It's VonGlinno and Mormon, "Managing Complexity in High Technology Organizations." There are others. Again, I've tried to cite some of these studies in my handout.

Before I shift to the final point on the non-price consumer benefits, let me add that fixed cost savings provide funds for increased advertising, product promotion, and customer service --some of this is obvious. But let me go now to the last point made on non-price consumer benefits, the diffusion theory, which is in the slide on the top of p. 13 of my handout. Gary Roberts and Steve Sallop have written an article titled "Efficiencies in Dynamic Merger Analysis," published in 1996, in which they point out very clearly that price reductions made by a company tend to diffuse throughout the market. This diffusion has a multiplying kind of effect, and the authors acknowledge that, similarly, non-price consumer benefits can have the same kind of multiplier effect through diffusion in the marketplace.

I've spoken a lot now about the importance of fixed cost savings. The key question remaining is, when do they count? As shown in the slide on the bottom of p. 13 of my handout, I think the obvious answer is that one has to decide for each specific merger. It's a little different from variable cost savings, which are important in virtually every merger. There are going to be some industries in which fixed cost savings are going to be more important, and some industries or markets in which fixed cost savings will be less important. There are a number of factors that one might consider in judging the importance, to include the following:

First, judge the potential impact of fixed cost savings on prices within the market. Next, judge the weight to be given to potential non-price consumer benefits by assessing the value of such benefits within the particular market. For example, there are some markets that are driven by non-price factors. In consumer electronics, a reduction in variable costs might not be considered so important. The development of a new technical concept underlying consumer electronics, however, might be deemed very important.

To continue, as shown in the slide on the top of p. 14 of my handout, fixed cost savings should receive much more credit in markets where there are other competitors having a more efficient cost structure. The fact is that there are many mergers that involve markets where the target company is unable to compete against the more cost-efficient market leaders. I think in instances where the merging companies are less efficient, it's easy to place a value on fixed cost savings, because in these instances, fixed cost savings are highly likely to be used in ways that lead to consumer benefits.

Next, one should assess the effect of fixed cost savings to the merged firm's cost of capital or to its internal business decisions and its internal hurdle rates. If fixed cost savings are sufficiently large to measurably reduce the cost of capital of the firm or to positively affect credit ratings, you can feel certain that there are going to be new investments undertaken that wouldn't have otherwise been undertaken.

I certainly encourage companies I'm representing to be very specific in terms of consumer benefits from fixed cost savings, and hopefully, most merging parties will do that and try to identify very specific projects and the consumer benefits that would arise from a lower cost of capital.

I think you should judge the intent of the merged firm to use the fixed cost savings to grow the business. There are a whole slew of things that one could look for in this area. First, are the post-merger business plans projecting greater growth than the combined stand-alone plans predict, for reasons other than price increases? Look for evidence of intended new product development, greater investment in R&D, proposed market expansions after the merger. Look for evidence of pre-merger capital constraints, rejected investment opportunities, any trends of either of the merging companies toward competing only within niche markets relative to the other competitors in the market.

Also you may see mergers that are proposing, and you've judged them to be true, very qualitative kinds of synergies and complimentarities that would allow you to conclude that possible new products or more efficient manufacturing processes could come out of the merger. In those instances, I think it's fair to say fixed cost savings are far more likely to be used in ways that benefit consumers.

Finally, I think you should try to assess whether past mergers or stand-alone fixed cost savings have been used to further consumer benefits. Establishing such a linkage between historical cash flows and consumer benefits would go a long way toward allowing the authorities to give credit for fixed cost savings.

Let me just finish up very quickly, referring to the slide on the bottom of p. 14 of my handout. I've mentioned AmeriSource/Bergen as an example where the responsibility for demonstrating consumer benefits rested primarily with the merging parties. I think they did an outstanding job of demonstrating that there were not just assertions and unverifiable representations being made, but rather there was absolute evidence provided on virtually every one of their assertions. In addition, they provided empirical studies showing that highly leveraged companies grow their business at a slower rate and typically have higher prices than other companies within the same industry that are better capitalized.

I have tried to identify just some of the information that one should look for in trying to assess the importance of fixed cost savings in a particular merger. I will not go further into them except to note that these are just some of many ways of trying to discern the importance of fixed cost savings. And let me just say in conclusion, I do believe that fixed cost savings historically have been given less attention and less credit than they deserve. At the same time, I think there is a move afoot by the agencies to give them the credit that they merit.

However, with that said, I do believe that the primary responsibility for demonstrating consumer benefits rests with the merging parties, not with the Federal Trade Commission or DOJ to go in there and prove your case for you. I am not advocating, when I talk about fixed cost savings, any looser standard for demonstrating cognizable efficiencies. They still must be merger-specific, they need to be verifiable, they cannot be the result of anticompetitive reductions of output or service, and, with rare exception, they still have to fall within the problematic market.

With that said, I have appreciated this opportunity, and I think I've taken a little longer than I should have. Thank you.

MR. DICK: I found David's talk quite persuasive on the point that we sometimes take too static a view of cost savings and efficiencies, and that we should be looking for cost savings that might come about over time through fixed cost savings, through R&D stimulation and other sources that may take a little bit longer to show up in prices and profit statements.

I'd like to pose one question to David first, and then I'll invite others to add their thoughts. One of your slides towards the end, David, said that credit should be accorded on a case-by-case basis to fixed cost savings. Specifically, you said that we should judge the potential impact of fixed cost savings on prices in the market. Should parties be prepared, in your view, to come in and say, look, in the last year, here's some very specific items on our balance sheet, or on our P&L statement that look like they're fixed costs, but here's how we have actually translated them into our pricing decisions? Should this be very company-specific? Is there a company-specific evidence hurdle that says we know that R&D has to be paid for somehow, and this is a very R&D intensive industry, and so you should give us some credit for the fact that we're likely to be able to achieve some fixed cost savings in the following cost categories?

What is the level of evidence, what is the level of specificity that you think companies need to make in order to persuade the agencies that their fixed cost savings really should be credited as a consumer benefit?

MR. PAINTER: I think that if you rely simply on studies, it becomes a battle of studies, I'm sure there are studies out there that will say something contrary to what some of the studies I cited say, and I think that without very specific evidence, it just simply becomes a matter of assertion and representation to the agency.

With that said, I advocate a practice that requires the merging firms to prove their point. If a merging firm wants to get credit for fixed cost savings with respect to pricing, then I think it behooves them to come in, and in every which way they can, either by using pro forma P&Ls that pricing managers rely on or by pointing the agency to pricing models that implicitly or explicitly take account of fixed cost savings, prove their point. Literally, when I say case-by-case, I think it has to be that.

I'll go one step further on this point. I believe that in demonstrating non-price consumer benefits - I probably will wish I hadn't said this - that you not only have to demonstrate that fixed cost savings are going to be used in a way that can enhance non-price consumer benefits, but I think you have to show that it makes a difference, that what is going to happen as a result of the fixed cost savings would not have happened without the fixed cost savings. I think that this goes beyond simply a yes/no answer, and would include showing that new products are brought to market sooner or they are brought to market at a lower cost through the merger. It's got to be something different happening with the fixed cost savings than would have happened without the fixed cost savings.

MR. DICK: Let me ask one follow-up question and then open it to the audience. One of your last slides also indicated that you thought that responsibility for demonstrating consumer benefits should rest primarily with the merging parties. I wondered whether that was a statement about the fairly obvious point that the parties are going to be best situated to have information about efficiencies, about whether they are fixed or variable cost savings that they're claiming, as compared to other economic issues that the agencies have to evaluate, such as market definition, competitive effects, entry. There are lots of different market participants that we can go to ask about how easy or difficult entry is, or whether some product is in the market or out of the market, but merging parties are particularly well situated to providing us information about efficiencies.

So, were you meaning responsibility in that sense, that they have a burden or responsibility to provide information, or were you going one step further to say that the burden of proof is on the parties to convince us that these efficiency claims are credible?

MR. PAINTER: Maybe it's a combination, but clearly one of the things that has impressed me since I left the Commission in 1997, based on the work that I've done since that time, is the amount of information that people on the outside, consultants, attorneys and the business people themselves, have access to that truly can be beneficial and help them present their case. Linked to that, it still amazes me how good a job the antitrust enforcement people do in trying to uncover that information through second requests and depositions and so forth.

I've been on cases where at first glance and in first interviews with business people, the response is, we don't have that; we know it's true, we rely on this guy for these kinds of things, so when he says that the fixed cost savings are going to be such and such, we know it's true. But subsequently, when push comes to shove, it is amazing how much information one can put together to raise the comfort level and the credibility of that assertion to a skeptical audience like the Commission and DOJ, an audience that really does need to be convinced of it.

There's a tremendous amount of historical information available within a company that literally will go to virtually every single efficiency point that I think can conceivably be identified with respect to a merger.

MR. DICK: Let me ask if there are questions from the audience. Yes?

MR. FINKELSTEIN: My name is Neal Finkelstein from Blake Castles in Toronto. I'm interested in the proposition that lower fixed costs can lead to lower prices, and I'm interested in the regulator's view of it. I was lead counsel to Superior Propane in the Superior Propane case, and I can tell you that in the Competition Tribunal, neither our economists nor the Competition Bureau's economists would accept that proposition, notwithstanding my best efforts. I'm wondering, number one, whether that proposition is acceptable to American regulators, and if it is, what kinds of evidence you look at?

MR. DAGEN: I guess that was addressed to me. I'm going to discuss that a little bit in my presentation, but the short answer is, I agree with most of what Dave has said in his presentation. Having come from industry, I know that fixed costs are involved in pricing decisions. Total costs are involved in pricing decisions. If you price for an extended period of time below total costs, you're going to be out of business. So, they are, in fact, considered.

I think from our perspective, regulatory perspective, in looking at fixed costs within the agency, we don't see a lot of them presented to us, so we haven't made a lot of decisions based on fixed costs. I think prior to my arrival here, there were some cases - Commission memos and/or in litigation scenarios – where we argued that fixed costs don't matter. But I think it’s incumbent upon the parties to demonstrate that their fixed cost reductions will, in fact, have an impact somehow or another on their competitive aspects of their business.

MR. FINKELSTEIN: But by using what kinds of evidence?

MR. DAGEN: Some of the evidence I'm going to talk about that they can use is how they have historically managed their business. Almost every company has cost savings programs within their business: ongoing total quality management programs, Sigma 6, numerous state-of-the-art cost reduction programs as they have progressed through the years et cetera. They have internally documented how these cost savings have benefited them in competition with their competitors. Companies should provide evidence of how they have historically been able to use their fixed cost reductions to promote price reductions, new product introductions, cost of capital reductions; any of those historical achievements from the merger; and tie them into the kinds of future pricing or other consumer benefits that may be achieved. This would be an adequate presentation that would allow us to evaluate fixed cost reductions.

MR. DICK: Bill?

MR. KOLASKY: Bill Kolasky from Wilmer, Cutler & Pickering. I just wanted to comment on David's comment that there's a conflict between what the surveys show as to actual business practice and what economic theory teaches, because there actually have been a couple of recent more theoretical works by economists that I think help to solve that apparent paradox.

There's a new book by William Baumal, for example, entitled The Free Market Innovation Machine which uses contestability theory to show that in markets where you have substantial recurring R&D costs and other substantial common costs, you need to be able to price-discriminate in order to stay in business, and therefore, very few customers, as you point out, pay prices that are equal to marginal costs. Most of the customers are infra-marginal, and the companies charge higher prices to those customers, which include an element of those common costs, and what constrains them from charging even higher prices is if they raise prices any more, that would attract entry from their rivals and drive the prices back down.

So, they are price-takers. They don't have market power, but they are charging discriminatory prices, and they need to do so in order to be able to stay in business. If they were not doing so, they would not be able to stay in business, and, obviously, in those circumstances, savings in those common costs, recurring R&D and even some G&A expenses will directly benefit customers by reducing the prices charged to the infra-marginal customers. There's also an article by Michael Levine in the Journal of Regulation that makes the same point.

The other thing I just wanted to comment on is again for David -- I think that one needs to be careful in using the term "fixed cost," because whether or not costs are fixed depends on what the competitive decision that you're making is. In the case of airlines, which is the classic example, obviously, the cost of each seat is the marginal cost and may be close to zero. But if you're deciding whether or not to add an airplane then it's the cost of flying the airplane. So I think that you may be better served by talking about incremental costs and common costs rather than just the blanket term "fixed costs."

MR. DICK: Time for one more question.

MS. TRIMBATH: Susanne Trimbath, Milken Institute. I'll just add a little bit to what David said in terms of the cost savings potential. I showed some of my research results yesterday but certainly there wasn't time to do everything. The research I did is covered in the book that we talked about, Mergers and Efficiencies. Basically, I did find some evidence that the cost savings were coming from SG&A and not from cost of goods sold. I didn't really focus in on it because I didn't realize at the time how important it is. I'm very surprised to hear that the FTC is not seeing a lot of claims of cost savings, in particular fixed cost savings, because it seems to me that the SG&A savings are the most obvious and the easiest ones to find.

In order to actually change manufacturing costs, you would have to be looking at a firm that somehow had fallen behind its industry in the manufacturing processes, so that you could update their equipment, for instance. I think in the steel industry, there was a situation where they were updating the manufacturing process itself through mergers. That was actually affecting what would amount to the fixed part of costs of goods sold. Frank Lichtenberg's study of manufacturing plant change of ownership reflected great savings from overhead. So, the cost savings are certainly there, and it's very surprising that they're not being shown to the FTC in the pre-merger review documents.

Another thing that I'll mention that David talked about was the effect of leverage. We found that the most aggressive cost cutters, ex post, were those that had higher levels of debt. Now, whether it's cause and effect, I'm not sure. I can't look into the minds of the people doing the mergers. Whether they cut costs more aggressively in order to service the debt or whether they used the debt to do some sort of changes, for instance, in equipment that would make them more efficient, can't be discerned in a large sample study. But there certainly is evidence that there are more cost savings associated with merged firms who have the higher levels of debt in place.

Just to put this in the form of a question, yesterday some of the consultants said that one of the key elements of success in a merger was to have a detailed integration plan. I'm wondering if the FTC is not seeing the evidence presented up front because the merging firms have not gone sufficiently deep into their integration plan to be able to say, “yes, we'll need fewer people in human resources,” “we'll only have one computer system,” something of that nature, and that's why they're unable to present it. If any of you could comment on that, I'd appreciate hearing it.

MR. DICK: If I can use my role as moderator to hold that question in abeyance, I think it's going to feed into some of the things that Gabe's going to talk about, and I want to make sure we have time. It seems like a natural segue into the very practical nature of what the agency sees and what it needs to see in evaluating efficiency claims.

MR. DAGEN: Good morning, and thank you, Dave and Andrew.

Yesterday, we heard a number of esteemed speakers talk about the factors involved in achieving a successful merger and achieving cost savings, synergies or efficiencies, and there were some questions yesterday about what the appropriate definitions of those were, and they're all slightly different. But those were some of the key factors that made a merger successful. Standing here today, I would say that I agree with most of the assessments made yesterday.

Stock price review gives mixed results of merger success. Efficiencies are often competed away. Efficiencies or cost savings are achieved in most cases. The magnitude is dependent upon the integration planning and successful achievement of the plan that's put into place. I also wholeheartedly agree that cost savings are usually achieved in the magnitude claimed by the merging parties.

I also agree with Dr. Scherer's assessment that a large portion of the savings claimed can be achieved without this particular merger or without any merger. This is where the synergy and efficiency analysis that the agency does diverges from the synergy or cost savings analysis that the corporations do in preparation for either their offering or their takeover bid.

What I plan to do today is talk about some efficiency claims experience that the agency has seen, and I'm going to go over some of the Merger Guidelines that specifically address some of the topics Dave was talking about -- how they play into the divergence between corporate cost savings and the analysis that we perform. Specifically, as seen in the slide on the top of p. 1 of my handout, I will talk about merger specificity, verifiability and the cognizability of efficiencies. Then I will briefly mention what we would like to see. I'm going to go into a little bit of detail about the kinds of things that we actually do see submitted to us. Then I'm going to talk a little bit about how merging parties can provide the information that we would like to see.

The first area that I want to talk about is cognizable efficiencies. As seen in the slide on the bottom of p. 1 of my handout, by cognizable efficiencies we mean efficiencies that are merger-specific, that have been verified and do not arise from anticompetitive reductions in output or service. To begin, I want to talk about merger specificity as it relates to cognizability. As seen in the slide on the top of p. 2 of my handout, efficiencies are merger specific if they are "likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects". That's one of the criteria for the agency to recognize the efficiencies as cognizable.

The second area that needs to be achieved is that the efficiencies have to be verifiable. Verifiability isn't really explained in the Guidelines, and there's a little leeway there. It's very difficult for merging parties to submit data that's verifiable to us, because we're talking about an act that's going to take place in the future.

So, what I propose, and the way I suspect that would benefit merging parties the best, would be to submit data that is supported by company documents. It could be business plans. It could be balance sheets, income statements. It could be trial balances, expense ledgers, capacity reports, product profitability reports, whatever documents they have that have substantiated past savings and that will tie into what they're reporting to be future savings.

We understand that the identification of efficiencies and the magnitude of these efficiencies require some guesswork and some estimates, but it's important that the parties, in fact, take this upon themselves to do, and do it in as accurate and supportable a way as possible. It's very unlikely that the merging parties have access to one another's records. They're not available in large part because of what's going to be talked about later, which is the gun-jumping issue in a merger analysis. But if a deal is being done, enough should be known so that it is possible to make a reasonable attempt at quantifying the efficiencies.

As discussed extensively yesterday, pre-merger planning is a key to success in integrating a merger. So, you have to plan it, you have to know where the efficiencies are coming from, and you have to be able to establish what you're going to do after the merger. We would like to see that analysis that's being done by the corporations. If it's not being done, it makes a pretty good case for the fact that the companies may not be able to achieve all the efficiencies that they're submitting to us.

I want to address what we receive from parties and how we analyze what we receive. Efficiencies are generally grouped and itemized to us in the following manner. We get efficiencies that are corporate overhead savings. We get efficiencies that are divisional overhead savings. We get R&D savings; procurement savings; distribution savings; production savings; and sales, general and administrative savings. Those are the main categories that the savings we see fall into.

I'd like to tell you a little bit about how we analyze those groupings. To start with, corporate overhead would, for the most part, fall into what Dave would classify as fixed overhead. Now, corporate overhead would also fall into the category, for the most part, at least historically within the agency, of savings that are likely to be achieved with the merger but unlikely to be cognizable under the Merger Guidelines. They can very well be very substantial, and in some cases, there may be an argument made so that they are cognizable and merger-specific; however, there's usually an alternative opportunity for merger that would allow the same corporate overhead reductions to be achieved.

The other portion of the analysis with corporate overhead that we see quite frequently is that when submissions are made, we see one of the two companies' entire corporate overhead eliminated in their projected cost savings, and this clearly can't be the case. In some cases, when it's a big firm taking over a small firm, it may, in fact, occur. But if it's two firms of relatively equal size, for instance, a corporate audit department won't be able to be completely eliminated. In fact, it's probably going to have to stay proportionally the same size as it was before the merger. Legal expenses to a large extent and possibly even human resources may fit it this category.

So, the analysis has to be pretty concise for us to accept the corporate overhead savings, as well as give us an indication that they are, in fact, merger-specific.

Divisional overhead is the next area that I mentioned, and it's probably more likely to be merger-specific. The divisional overheads for two companies that are merging probably have a lot of duplicative resources that can be eliminated with the merger. They are likely to be achieved, and the analysis that's submitted should be detailed enough to substantiate them. The divisional overhead savings may, therefore, be considered to be a cognizable efficiency.

R&D savings are not usually considered cognizable under the Merger Guidelines, because they usually result in a reduction of output. R&D cost savings submitted from a merger are usually a result of personnel reduction such as researchers, not managers. The savings would likely result in a reduction of output. If however, infrastructure was eliminated, and the costs to run the R&D department were reduced, they might qualify as a cognizable efficiency.

Procurement is another area that we almost always see in a submission of cost savings and efficiencies, and I think there is agreement that procurement savings are likely; however, the position taken is that procurement savings are pecuniary and that it's just a transfer of profits from the supplier's pocket into the buyer's pocket through a bit of buyer's market power and fear of loss of business from the supplier. Nevertheless, there could be savings that are cognizable. Increased capacity utilization at suppliers post merger, resulting in reduced production costs which are passed through to the merged firm, would be an example.

Distribution savings are frequently presented in consumer and business product mergers. Usually in distribution, there are a lot of variable cost savings, and we, obviously, acknowledge those. As Bill mentioned earlier, we shouldn't be talking about fixed and variable -- the fixed cost savings in a distribution environment aren't really fixed. They're fixed to the extent that you have equal monthly payments or equal depreciation on a business, but the business, in fact, is distribution, and as you gear up or increase volume running through that distribution center, your costs to run it on a per-unit basis are actually variable. If a merger doubles the volume that's taking place at a distribution center, the product costs don't change, but the distribution expense, which is your cost of goods sold, so to speak, of running the business do, in fact, change.

For production efficiencies, we look at fixed and variable cost savings. Consolidation of manufacturing between facilities of the acquirer and acquired, insourcing from more expensive contract manufacturers, and utilization of more efficient production processes would all be analyzed for cognizability.

Submissions of SG&A savings are frequently lumped together as one cost saving. The G&A portion of these savings are usually corporate overhead and I have already discussed these. The sales savings, however, may be cognizable and we would look to determine whether they are merger specific and verifiable.

Now, I'd like to talk a little bit about what we actually receive from the parties in the way of submissions. To begin with, the big cost savings numbers that you see in press releases are usually the numbers that appear in the initial investment banker's analysis of the deal. This is often the number that's calculated to help the parties determine the premium to be paid on the deal. It may have been arrived at through analysis of comparable deals. As we all know, each deal is different and every company’s operations are different. While calculated to justify the deal price, these savings rarely have any relationship to cognizable efficiencies.

Companies can usually achieve cost savings significantly greater than the cognizable efficiencies recognized in the Merger Guidelines. However, the achievable cost savings are the cost savings that are usually reported to us. The shortcoming of reporting these is that the merging parties haven't met their burden of providing cognizable efficiencies to the agencies, which is something Dave mentioned earlier. We get efficiency studies that really are cost-saving studies, and they are not done on a micro enough level from the parties' standpoint to present cognizable efficiencies to us. We then dig into them and try to figure out which ones are merger-specific and which ones aren't. This leads us to identifying non-merger-specific efficiencies. It reduces the number that is reported, and then the number that's reported becomes less reliable to us.

As the cognizable savings decrease from the reported savings, the reliability of the efficiency claims tends to decrease. This may pose some risk for the parties when the efficiencies are examined as a defense to effects. This could be either at the Commission or at a Preliminary Injunction hearing.

I want to give you some specific examples of some of the specific efficiencies that we've received recently. We had a merger recently between two parties, they were international companies, and we were looking at North American efficiencies. Each company owned two factories in the United States, and to protect the innocent or guilty, I'm not going to use any names in any of these cases.

One of the companies (call it Company A) was running each of its two plants at 85 percent capacity, and the other company (call it Company B) was running each of its two plants at approximately 35 percent of capacity. The efficiency claimed was based on the plants of Company B combining. The merged firm was going to consolidate both Company B plants into one plant. They were to shut down one and increase the capacity utilization to 70% for the remaining plant. Well, obviously, that would result in cost savings, and, obviously, it could have been done without a merger.

Another recent merger consisted of two companies that manufactured large industrial products. Company A was the low cost producer in some product markets and Company B was the low cost producer in other product markets. Both companies competed in all of the product markets. The lower cost producer usually achieved a significantly higher market share.

The parties claimed that the merger would result in significant savings by transferring the best practices methods of the lower cost producer to the other firm. They first calculated how many total projects each company completed annually prior to the merger. For example, Company A, prior to the merger, built 96 Industrial Structures and Company B, in direct competition, built only 4. Company A could build these structures for $100,000 while it cost Company B $120,000 to build their version. As can be seen by this example, if the merged firm adopted Company A’s methodology, it would achieve a savings of $80,000 (4 projects times $20,000 per project). However, the parties insisted that they would achieve $2 million in savings because after the merger they would be building 100 Industrial Structures at a savings of $20,000 each. Clearly there were no savings achieved by using Company A’s methodology to build the 96 projects they would have built using the same methodology without the merger.

Another claim submitted by merging parties had to do with consolidation of operations. Prior to the merger, there were three operating divisions in the one company, and they were going to merge a similar type of company into their operations and set up a new division. The savings that were calculated encompassed not only the savings from incorporating the new division, but incorporated the savings of merging the three divisions that were in existence prior to the merger. A substantial portion of the savings were for the operations that were in existence prior to the merger. Again, savings like this tend to make other savings that maybe are achievable and cognizable look less reliable.

And the final example I want to give is, again, a recent case where one company had underutilized manufacturing operations, and it was merging with a company that produced product as well as toll-manufactured the product. After the merger, the underutilized manufacturing operation was going to manufacture the product that was toll-manufactured. While this would generally be cognizable, there was significant evidence that the products produced were so different that their engineers weren't sure that they could be manufactured in the same facility without a major investment. There was also some evidence that even if they could manufacture it in that facility, that the toll manufacturer was a lower cost producer than what could have been achieved in-house after the merger.

These are some examples of the efficiencies we see submitted to us that are probably conceived and considered at a high level in the merging parties' organizations. As these examples indicate, when integration planning and efficiency claims aren't well thought out prior to coming to us, they tend to be considered non- cognizable by the agency.

Now, here's what we would like to see. It's pretty simple. We would like to see a submission of cognizable efficiencies presented to us in a verifiable manner. The first question I think we addressed earlier is, does this include fixed costs such as the ones David spoke about. As shown in the slide on the bottom of p. 2 of my handout, the Merger Guidelines state that "efficiencies…, which enable the merging firms to reduce the marginal cost of production, are more likely to be [cognizable]."

Variable costs are used as a proxy for marginal costs in a lot of the economic analysis. As David mentioned, there are a lot of gray areas. I won't go into detail but fixed costs should be considered in situations where fixed costs may not really be fixed. Distribution was an example that I gave earlier.

As seen in the slide on the top of p. 3 of my handout, there's another part of the Merger Guidelines that states, I quote, "The Agency also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market." You can infer from this that if it's a cognizable efficiency and it doesn't have short-term direct effect on prices, it may be what we've been talking about as fixed costs. So, the Guidelines may leave open consideration of fixed costs.

And this last slide on the bottom of p. 3 of my handout tells us how savings, both fixed and variable, including overhead, may relate to pricing or capital reduction. The Merger Guidelines state that "the merging firms must substantiate efficiency claims so that the agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved and any costs of doing so, and how each would enhance the merged firm's ability and incentive to compete." I think that's important, and it doesn't say reduce price, it says enhance the merged firm's ability and incentive to compete.

It's important to recognize that it's incumbent upon the merging parties to let us know how efficiencies are going to be used, not have us try to infer how they may happen, and why each one of those would be merger-specific.

Just to put all this into perspective, over the last five years, the agencies have received anywhere from 2000 to 5000 HSR filings. Only about 2-3 percent of these filings have a second request issued. Approximately 80 percent of those where a second request is issued either we allowed to proceed without challenge or have a remedy and are fixed with a consent order, which usually requires divestiture, and only about 0.1 percent of all the filings are litigated. These numbers reflect the fact that achievable efficiencies are preserved in almost all mergers filed with the agencies. Furthermore, even when divestiture is required, the parties are likely to still achieve efficiencies from combining their non divested assets.

Claimed efficiencies play a large role in determining whether to challenge a merger, carve out a divestiture or let the transaction occur without modifications. I'd say that in an HSR filing where the vast majority of cases just run through the agency, there's probably no benefit to doing an efficiency analysis. But if we're talking about the 2-3 percent where a second request is issued, there's probably some benefits to providing a detailed efficiency analysis.

So, just to wrap up, what we'd like to see is a cognizable efficiency presentation to us that includes both fixed and variable cost savings with a detailed explanation of how these savings will be achieved and how they're going to affect the competitive environment that the parties are operating in.

MR. DICK: Thanks very much, Gabe, for your practical discussion about what we do see and what we'd like to see.

I'd like to make just a couple of short observations. As you point out correctly, very few cases eventually are litigated or turn on efficiency claims in litigation. But I don't think that should let us lose sight of the importance of an efficiency story and hearing that up front. It's extremely important, particularly during the first 30 days of an investigation, for the parties to provide the rationale for the deal, and that frequently is framed in terms of the efficiencies that might come from the deal.

Obviously, they can't do that or frequently won't be able to do that with the same degree of specificity and detail and backup that we would eventually like to see if, in fact, efficiencies really turn out to be the decisive issue. But that shouldn't dissuade and in my experience frequently doesn't dissuade parties from explaining up front the rationale for the deal and the efficiencies, the synergies that they anticipate. Of course, some of those may not be specific to the deal, but they're presenting the deal that they're presenting. They're coming forth with this particular merger, not some other merger or some other joint venture, and so it's natural in the first 30 days for them to adopt something less than a merger-specificity standard when they're explaining the rationale. But that's extremely important, because it helps to frame the rest of the investigation.

The second observation that I would like to make is that parties ought to take advantage of the full range of types of information that they can provide to us. Gabe picked up on this point in his remarks in part. It's extremely helpful to provide information on efficiency claims from a number of different angles. Admittedly, sometimes that information will be a little bit contradictory or it will simply reflect an updating, a natural updating that the parties will go through as they get more information themselves, as the second and third-level managers in the company start talking with one another or they start sharpening their pencils a little bit more. But the fact that there may be contradictions, the fact that the efficiency numbers may bounce around during the presentations to the division or to the FTC hopefully shouldn't dissuade them from bringing in those people from within the company or providing the documentation, providing the analysis, because that's extremely helpful to the agencies.

It's also, obviously, very helpful if there is an historical record of past mergers involving the same companies or other forms of integration short of merger that generated efficiencies. So we can sort of test what has been the track record of this company in terms of actually meeting its claimed efficiencies. That can often be extremely helpful to evaluating current efficiency claims.

Let me pose some questions to Gabe. How specific do the parties need to be at different stages of their presentation? What types of evidence do they need to be bringing in? Do they need to be providing a complete efficiencies story, do they need to be providing the analysis or do the agencies really just want to see the hard facts and numbers and we'll crunch them ourselves? What type of balance between providing the story, providing the analysis, and providing the backup information is the FTC looking for?

MR. DAGEN: I think we look for all three. I think we want the story as to how the efficiencies are, in fact, going to be generated. We'd like the parties to do the analysis. They're the ones that have the data. We don't have the data, and we'd like them to point us in the direction of the data and supply us with the backup that, in fact, their analysis is based on.

One of the key issues that we see here quite frequently is that one company is doing the efficiency analysis and they're doing it without data from the second company. The first company makes assumptions on the data of the second company, and as long as the assumptions are somewhat based in historical data, we can verify the other company's data and see if, in fact, some of the savings that are being anticipated are being calculated correctly.

Problems may arise, however, when a company, for example, bases its efficiencies claims on best practice savings. Although some can be quantified, it's hard to quantify best practice savings. In attempting to quantify best practice savings, the first company may say, well, we do this process so much better than the other company. But in deposition testimony, the other company claims to be just as efficient as the first company, so some of the savings maybe are unrealized. Therefore, it's important for us to be able to verify, in fact, the savings that are being claimed by the party submitting the efficiencies. By them supplying backup and the second company also supplying the information that's requested, we're able to do a test check on whether or not the efficiencies claimed are cognizable.

MR. DICK: Do we have maybe one quick question?

MR. SCHEFFMAN: I'm going to have to take over, because we are going to run late. There may be questions, and Gabe and David will be around if you want to ask them questions.

Let me just say, because we have many people from agencies outside the U.S., Gabe's job, as all of our jobs as enforcers, is to be skeptical about efficiencies claims, and he's good at doing that. That doesn't mean that we don't seriously consider efficiency claims.

I think a problem on the outside is that outside counsel are quite willing to be advocates on competition issues, and that's fine, that's their right. We don't give those any credibility, of course. Now, on efficiencies, you have a duty of good faith, because we have to rely on you a lot, and we need corroboration and documents and other things, so that's a problem. If you stretch your efficiency claim, it's going to disappear, because we rely on good faith.

Second, I think there's a problem of not involving financial analysts in developing efficiencies. When I did work on the outside and on efficiencies, I always had a financial analyst involved, because an economist is not a substitute for a financial analyst. In efficiencies, you get into these issues about how costs are allocated and other sorts of things, and you really need financial expertise in doing that. You're usually not going to be able to use your internal business people, because they don't really understand the sort of analyses we are going to have.

But to go back to what Chairman Muris said, we think efficiencies of all kinds are important. We would like to see better presentations. We don't think, as the Chairman said, that there are many cases where efficiencies are going to make the difference, but there are some. There are more of them than we see, and I thank the panel for very interesting presentations, which will be available on the website. We also will get a bibliography of the articles David Painter cited, and that will be available. The next session won't start until 11:00, so thank you very much.