Interview with David Scheffman, the FTC's New Director of the Bureau of Economics

ABA Section of Antitrust Law "Brown Bag" Program

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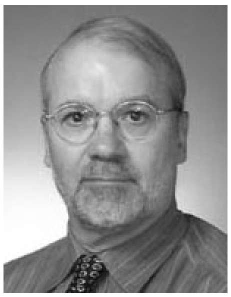

SPEAKER

David Scheffman

Director, FTC Bureau of Economics

MODERATOR

Philip Nelson

Chair, ABA Section of Antitrust Law Economics Committee

Editor's Note: *The insider's insider, David Scheffman returned to the FTC this past year to head the FTC Bureau of Economics as Director, having previously served as an economist in the Bureau from 1979–88, and in senior management positions from 1982–88, including as its chief from 1985–88.*

Prior to rejoining the FTC in June, Dr. Scheffman was an economic and business consultant and Professor of Business Strategy and Marketing at the Owen Graduate School of Management at Vanderbilt University. He continues to teach business strategy as an adjunct professor at Vanderbilt and at the Johnson School of Management at Cornell. While a consultant, his practice included business consulting and antitrust economics consulting and serving as an expert witness in antitrust cases and other complex litigation.

Dr. Scheffman received his B.A. in Mathematics and Economics from the University of Minnesota and his Ph.D. in economics from M.I.T. He is the author of many articles and books in the areas of industrial organization and antitrust economics, law and economics, and marketing and business strategy.

Dr. Scheffman was the guest speaker in the following interview moderated by Philip Nelson, Chair of the ABA Section of Antitrust Law Economics Committee and a principal with Economists, Inc. in Washington, DC, as a "Brown Bag" session sponsored by the Antitrust Section. The "Brown Bag" program, which took place on September 26, 2001, offered Antitrust Section members an opportunity to hear comments from Dr. Scheffman, which were followed by a question and answer session led by Phil Nelson.

The Antitrust Source is pleased to present this edited and updated version of the transcript of that session, which also includes Dr. Scheffman's responses to additional questions posed by our Editorial Board.

PHILIP NELSON: Today we have the opportunity to spend some time with David Scheffman, Director of the FTC's Bureau of Economics. David will start by making a few introductory comments. Then we will open the floor to questions.

DAVID SCHEFFMAN: Of course, I don't speak for anyone at the Commission, other than myself. With the new group, we do want to communicate to the Bar, and I to the professional economists who work on matters that we're involved in or share an interest in, to try and be as clear and transparent as possible about what we're thinking, what we're doing.

It's fair to say that we have a very economics-oriented group of senior staff. We have a Chairman, Tim Muris, who can rightfully claim to be an economist. The Director of the Bureau of Competition, Joe Simons, is a very smart guy who knows a lot of economics. We have Bill Kovacic, General Counsel, who knows quite a bit of economics. Joe Simons has an economics assistant named Mark Frankena, an old classmate of mine who worked with me at the FTC. So we have a group of people who are quite comfortable thinking about things in economic terms.

Those of you who are practitioners should read Chairman Muris's speech to the ABA at the Annual Meeting "Antitrust Enforcement at the Federal Trade Commission: In a Word—Continuity" (Aug. 7, 2001), http://www.ftc.gov/speeches/muris/murisaba.htm because I think you should take what he says as being a fact. That is, in my opinion, I don't think any of us see any significant change in policy occurring. From my perspective, the way we look at things, I think, is probably to some degree different from the people who preceded us because we're more economics-oriented, but we don't see any need or justification for any significant change in policy.

The Pitofsky Commission was extremely well run and had high quality staff in all the bureaus and management positions. We have a group of people who (1) all worked together before at the FTC, and (2) probably are more sympathetic to looking at things in terms of economics and are more comfortable with that. That would probably mean some differences, maybe, in how we look at certain things in some specific situations.

But as the Chairman said in his speech, we don't see the strength of economics in theory. We see the strength of economics as providing methodologies for empirical testing and for developing data, or as the Chairman said in his speech, "stubborn facts." In my opinion, we're not going to make recommendations for prosecutorial decisions based on economic theory as opposed to facts guided by economics and other analysis.

We see the strength of economics as providing methodologies for empirical testing and for developing data, or as the Chairman said in his speech, "stubborn facts." In my opinion, we're not going to make recommendations for prosecutorial decisions based on economic theory as opposed to facts guided by economics and other analysis.

I think the Bureau of Economics will have a more important role with some people in the Commission than it did before, even though for many years now it has had an important role. I was at the Commission in the 1980s and that was a very different time. I became the head antitrust economist when Tim Muris became the Director of the Bureau of Competition, and that was a very big change. That was just after Bill Baxter issued the Merger Guidelines and when antitrust policy truly fundamentally changed and, in my mind, caught up to where the case law, mainstream economics, and common sense were. Those were very different times—in a real way, the Bureau of Economics and the Bureau of Competition were at war with one another. It was an intellectual war about what antitrust law and policy should be. I think that was a useful war, but that war is over. Not surprisingly, many of us that were in the antitrust agencies in the 1980s think we "won" the war. The best evidence of that is that we are basically comfortable with general policy of the past eight years. In any event, we're not at war anymore.

It's nice to be back with the Commission. We work very cooperatively with the lawyers. We're dealing with very different matters now. Before, there was fighting between the Bureau of Competition and Bureau of Economics about whether to block a 7 to 6 merger with (from the economists' perspective) little economic evidence of potential anticompetitive effects beyond that the level and change in HHI tickled the Guidelines. Most of the matters we're dealing with now clearly raise significant potential competitive issues from an economist's perspective.

Some more specifics about what we're doing: Tim Muris brought me on to do some specific things. One of the first things we did, working with Dennis Carlton, was to convene a group of leading industrial organization economists to come in and talk about what is the most current thinking and research in *empirical* industrial organization economics, which can help us guide our decisions, and what is the sort of research in empirical industrial organization economics that would advance our ability to contribute to antitrust investigations.

That conference was, unfortunately, scheduled on September 11. We actually went forward with the conference. The conference was going to begin just before the terrible events of the day began to unfold, and all the participants were there. We had to decide, well, what are we going to do? And we talked about it seriously at the time. All of our folks were from out of town, they weren't going to go anywhere and we decided to just go ahead. The participants, the panelists, and people who wanted to stay in the audience, said we would just go ahead, despite the tragedy of the day; we were there to do something and it seemed like the best thing we could do under the circumstances. So that's what we actually did and, although under terrible circumstances, we had a very good conference.

We had a very good discussion and the participants were Dennis Carlton, Dick Schmalensee, Jerry Hausman, Ben Klein, Mike Whinston, and Janusz Ordover. Steve Salop, unfortunately, couldn't make it because of the events of that tragic day. The idea was to get a cross-section of leading industrial organization ("I.O.") economists who had considerable experience in antitrust investigations and litigation. So we had a very good discussion of where we think I.O. is; what is the empirical basis of I.O.; what it tells us about what we should be doing and how; and what sort of things we should be doing in the future, what sort of new research exists or would be helpful.

A significant focus of the conference—maybe a third of it—was talking about another thing that was particularly on Tim's agenda when he asked me to rejoin the FTC and has been on my agenda for a long time: what do we think about these econometric analyses of scanner data and unilateral effects theories? I have long had concerns that the practice has gone faster than the science. We had considerable discussion among the economists at this panel and there was largely a general consensus. Jerry Hausman is probably the most responsible, of any single person here, for stimulating this approach to branded products merger analysis (even though we had actually done such analyses when I was at the FTC in the 1980s). It was the clear consensus of the panel that this sort of analysis should be, at most, an input into the decision process; it's not *the* answer. There was also quite a lot of discussion about potential limitations in these analyses that we need to think about, and people are beginning to think about this now. I actually wrote a paper about this long ago, but until recently no one paid much attention to it.

Let's talk about the scanner data analysis. We're doing a lot of work in the Bureau of Economics on that. We have been working with some prominent outside econometricians. We have posted a short summary of our findings on our Web Page [http://www.ftc.gov/be/econometrics.htm] and will have a Bureau of Economics Working Paper out in January. We've probably done more scanner data analysis than anyone, other than maybe our friends at DOJ. We're doing a lot of thinking and working on scanner data analysis. I hope to talk to some of you economists more about this when I visit the various economics consulting companies, to talk about what we're thinking or have you come in and tell us what you think, which we'll be doing, too.

Let me briefly summarize some of our thinking, which of course is still in progress. There are issues in the data that economists have not really addressed. I've been a marketing professor for a long time, so I actually know quite a bit about these data. I had a market research person come in July and spend a day with us talking about the Nielsen and IRI data and its plusses and minuses. We know there are some potentially significant issues about the data, but, as far as we can tell, the economics literature and economists have not really addressed issues like the potential implications of having data aggregated up to the city level. For you economists, that may lead to some problems in the specification of the model, it raises some statistical issues, and it may confound things in that it aggregates in an unfortunate way the promotional activity. The aggregation may lead to not having a good match between the promotional activity and prices. And we know from market research and even from economics research, such as Mike Katz's and Carl Shapiro's paper on coffee years ago, [Michael A. Katz & Carl Shapiro, *Consumer Shopping Behavior in the Retail Coffee Market, in* Empirical Approaches to Consumer Protection (1986)] that there can be very strong interactive effects between promotions and prices. That is, if you have a hot price in the supermarket and you promote at the same time, say, with an end aisle display, the expansion in sales is much bigger than if you do just one or the other. So it's very important to match the promotional activity with the prices. When you aggregate up to a city level, that matching can be problematic.

There are also issues in the inference—the statistical inference, t-statistics, confidence intervals, etc. It's actually quite complicated to estimate key statistics such as standard errors, t-statistics, etc. This is because—I'll do some "econospeak" for the economists—we're doing linearization *approximations*. And the linearization is two or three levels removed from the core statistical estimates. We need to think some more about that. For example, we've found, in some cases, doing sampling distributions that you get some warning signs about the lack of robustness of the estimate and the potential unreliability of the estimated standard errors.

I have said for years now that there's an issue in the modeling of the statistical estimation, which is that these estimates are coming from competition at the *retail* level. The estimates are a product, only in part, of what we're really interested in, which is the competition between manufacturers, which is the level where the merger occurs. This requires some serious thought rather than just a glossing over, as has been done in the past. I have been thinking about this for many years, and wrote about it about ten years ago. A number of people are beginning to think about this. There is a Ph.D. student at Berkeley working on this, Froeb and Werden are working on this, as are we.

I have said for years now that there's an issue in the modeling of the statistical estimation, which is that these estimates are coming from competition at the retail level. The estimates are a product, only in part, of what we're really interested in, which is the competition between manufacturers, which is the level where the merger occurs.

This wholesale/retail issue is, I think, in a way one of the most serious issues here. Since the 1992 Merger Guidelines, cases have increasingly focused on unilateral effects. It's interesting how different our investigations are from what they were when I left the FTC in 1988. In 1988 we were doing mostly coordinated interaction cases, but we didn't have many four-to-three cases. Strangely, we don't have many coordinated interaction cases anymore. (However, speaking only for myself, I suspect that we will have more). This has happened because of the powerful economic logic of unilateral effects: A diverts to B, or vice versa, or both, and A and B are merging; therefore, the price is going to go up. There is nothing wrong with that basic logic, except as to whether the conclusion is correct. What's missing here is a proper weighing of the strength of the evidence bearing on diversion, and that logic is independent of the competition in the marketplace. Of particular importance here is the wholesale/retail issue—what is the nature of competition at the manufacturer level and what is the evidence on diversion at that level related to *manufacturer* prices?

In the late '80s, because we were doing mostly coordinated interaction investigations, we generally did a very extensive investigation into what really drove competition in all its detail. However, we do less of this these days, particularly the economists—both inside and outside the agencies. That does not make sense. Think about the ready-to-eat (RTE) breakfast cereal industry. In the 1970s it could be argued that at least on price it was a pretty tight-knit oligopoly. In recent years, due to changes in the players and other changes, it appears to be a much more competitive (on price) industry. If we focused on econometric analysis of scanner data, the difference in the nature and intensity of competition *at the manufacturer level* would not really come into the analysis (except for calculated price-cost margins). In my view that doesn't make any sense.

We have to spend a lot more time, and we are now beginning to do that, investigating the actual competition between manufacturers. It appears to me that inside and outside economists cut back somewhat on such in-depth investigations of the nature and intensity of competition, in part, because it's hard. It's hard in grocery manufacturing (and a number of other industries) to get price data at the manufacturer level that is easy to use. We can't get nice data we can just stick in our computer and calculate average prices, let alone demand elasticity estimates, like we get with scanner data. On the other hand, we get prices that are actually set by the parties to the proposed merger and their competitors. So we're trying to spend more time actually looking at what drives the competition among manufacturers.

Remember, we tend to focus on price at the retail level, but grocery manufacturers compete on the quote "list" price, either the regional or national prices. But then there's all this other stuff like promotion, discounts, shelf and display payments, etc., where the real pricing action takes place, which deserves much more looking at than we have done in the past. Recall that this was an issue in the *Baby Food* case [*FTC v. H.J. Heinz Co.*, 116 F. Supp. 2d 190 (D.D.C. 2000), *rev'd*, 246 F.3d 708 (D.C. Cir. 2001)]. And beyond competition on price, there is competition on product and advertising, and in some cases, distribution.

One of the key things in looking at the competition in branded consumer products is that when we do this unilateral effects analysis, we're assuming that the competition is in some sense "localized." (For example, Kelloggs Corn Flakes competes significantly more directly, with, say Post Toasties than with other RTE Cereals—at the *manufacturer* level). Now that's a testable proposition—but at the *manufacturer* level. Is the competition really localized or is it really more diffused? Or is it really not localized? What we have been doing with econometrics analysis of scanner data is concluding that because our scanner data analysis says A and B have particularly strong cross-elasticity *at the retail level*, then, if the companies merge, they'll raise the price. Well, there are other relevant and important ways of looking at that. If A and B are particularly close competitors *at the manufacturer level*, if you look at the past history of the marketplace, then you should see evidence of localized competition between A and B at the manufacturer level, as opposed to some industries where you see the competition being more broadly based across all brands.

This critique of scanner data analysis and unilateral effects theories should not, again, speaking only for myself, be taken as an indication that we're more likely to view mergers between branded products favorably. That's simply not true. Rather, we need to expand and refine our analyses of competition at the manufacturer level, and, in some cases, we may actually be more interested in coordinated interaction theories than in unilateral effects. But this is not at all an indication that the policy is going to change. A three-to-two merger like in *Baby Food* is going to be a really tough case, no matter what. For confirmation of this, see the press release and proposed consent for the recent "rum" matter [http://www.ftc.gov/opa/2001/12/diageo.htm; http://www.ftc.gov/os/2001/12/index.htm].

Let me now turn to a different topic. I have been following and participating in the use of economists in merger investigations for many years now. It appears to me that the use of economists by outside lawyers has become much more limited. I have worked on a number of matters in which we did a lot of work, but our work was never used by the lawyers in presentations to the FTC or DOJ, even though, in my opinion, our work supported some of the parties' arguments. There appeared to be a view that the economists' work was not important to Commission decision makers other than to say the deal was okay and to do some econometrics analyses.

I'd urge the lawyers and economists who are going to come in and see us to have a much broader* empirical and institutional *perspective and basis of facts and evidence than just what your econometric analysis indicates.

I don't know if that approach was a mistake with the past Commission but it is certainly a mistake for the current Commission. Our decisions are not going to be made by economist pronouncements, as opposed to solid empirical economic analysis. The empirical analysis, econometrics analysis of scanner data, specifically, has to be thoroughly thought out and justified as being reliable and applicable to the issue at hand—the merger of manufacturers. So I'd urge the lawyers and economists who are going to come in and see us to have a much broader *empirical and institutional* perspective and basis of facts and evidence than just what your econometric analysis indicates.

A few other points. We're quite interested in and we are going to convene a panel of I.O. economists like we had in September—this time on coordinated interaction, sometime in the next few months. We will have a number of a prominent I.O. economists come in and talk about coordinated interaction because that's an area which I think has been much too de-emphasized as a potential concern in a merger. The issue is what does economic theory and empirical research contribute to developing the use of coordinated interaction theories in mergers and other antitrust investigations?

As I said at the outset, we are trying to become more transparent in our views and the basis for those views. Our aim, without unduly sacrificing our litigation position, is to be even more transparent, communicating to you what, as best we can tell, our real concern is and the bases for that concern. That said, I remember that almost immediately after I left last time, I had considerable difficulty figuring out what the Commission staff was thinking on some specific matters. But if I had thought about it, I would have realized, and, being back again, I now realize, that often the problem is that we don't really know for sure what the specific problem is. That is, we appear to have a significant potential problem, but we have difficulty nailing down market definition, or barriers, or competitive effects. For example, we may know that we have a *likely* four-to-three (e.g., market definition is not "air tight"), but we have a bunch of complicated evidence which points in different directions on competitive effects and barriers that we're trying to figure out. In this sort of situation we have enough of a *potential* concern with the transaction that we're not telling you to go away and consummate, but we're not necessarily telling you clearly what our concerns are because we might not yet be sufficiently sure. We think that there might be a case here, but we're still struggling with it. So, the fact that you don't get a crystal clear signal doesn't mean that we're not being transparent.

As I said a week ago at the Antitrust Section's FTC Committee Brown Bag program, and as I've told my clients on the outside, in that case, what you should do is write the closing memo for the Bureau of Competition. You've got to cover all the potential significant bases. We will be as transparent as we can, realizing, of course, that we may be in court with you in a few months. We're not going to give away our litigation position, but there's no reason for us not to be pretty forthcoming with our basic concerns and to have a reasonable debate about that.

I look forward to talking to you more in the future, especially the economists, to talk about what we're thinking about, what we're doing, and where things are going at the Bureau of Economics. Thank you.

NELSON: We will now take questions from the audience.

AUDIENCE QUESTION: Can you talk a little bit more about how coordinated interaction will be used to investigate a merger?

SCHEFFMAN: Coordinated interaction never went away entirely. Coordinated interaction is a basic situation in which the reduction in the number of players from, say, five-to-four or from four-to-three might reduce the competition sufficiently that you'd get a price increase, but that the parties to the merger could not raise price unilaterally. That has always been part of the Guidelines and of enforcement, but there has been a move towards more emphasis on the reduction in the competition between the parties to the merger causing a price increase. And that's a situation where the competition is quite localized. The two parties have enough post-merger control of price to raise price unilaterally as a result of the merger.

This is something that we're looking at, and, in my personal opinion, over time coordinated interaction may become more important. Of course, that decision is up to our clients, the Commissioners. What Chairman Muris asked of me, and I agree, is that we need to be able to deal with this. We need to understand the implications of relevant economic theory and empirical research for analyzing mergers under a coordinated interaction theory. This is something that really has not been revisited much, at least by economists at the practitioner level, for quite a while because we've been mostly all engaged in doing unilateral effects cases.

I was involved in some substantial coordinated interaction cases on the outside and did a lot of empirical work. I will be putting out a B.E. Working Paper early next year. So this is an issue which we, as economists, are charged with thinking about and getting some outside help thinking about—rethinking oligopoly theory and reviewing empirical research and what implications it has for how we should do investigations. We're going to be doing that. My advice is to look to make sure that the competition isn't broader than localized. The fact that it's broader doesn't mean that you don't have a case. For example, I didn't work on the Pennzoil/Quaker State "canned motor oil" merger, but I know quite a bit about that industry and I was quite surprised that the investigation appeared to focus on unilateral effects. From what I knew about the industry, I thought that there likely was a potential coordinated interaction issue, but I hasten to add that I did not do a thorough economic investigation of the industry. Beyond this anecdote, what it means is we should be looking at what really drives competition and how competition might be affected by a merger.

NELSON: As a follow-up to the question about coordinated effects, when economists model coordinated effects, they tend to use Cournot or Bertrand models. Is there an effort to determine what types of formal oligopoly models should be used? Or, is there a more general empirical effort to determine what types of information should be collected to determine whether the oligopoly is a particularly tight oligopoly, without getting into arcane issues about whether a Cournot or Bertrand model is the appropriate model to use?

SCHEFFMAN: Well, I think it's the latter that is likely to be more important, i.e., the empirical evidence bearing on the details of actual competition. I've done quite a bit of work on this. My forthcoming B.E. working paper will clarify what I think are some important empirical tests and what testing the relevant data would tell us about the viability of a coordinated interaction theory in a particular case. Determining that a coordinated interaction theory is valid is probably harder than developing empirical analyses that tend to show that a coordinated interaction theory is probably not valid (if the facts are there). Economics doesn't provide much guidance. I remember we had the old Posner checklist: Is the product homogeneous? What is the frequency of transactions? Are they big, lumpy transactions or frequent? And so on. That checklist doesn't really give us much help at all. When we were doing a lot of coordinated interaction investigations in the late '80s, we'd actually advanced pretty far away from that, and looked in various ways at competition and in various empirical ways at the evidence of whether there was significant coordinated interaction and whether it would be facilitated by a particular merger. I can't tell you more than that. I think that the art did advance significantly in the agencies during the late '80s, but there was hardly any literature that came out of that experience. So we're going to have to rethink that and we're going to be talking among ourselves and with outside industrial organization economists about what are the empirical approaches we should use in deciding whether we have a viable coordinated interaction theory or not.

ANTITRUST SOURCE: What are you saying about the calculation of the price-cost margin or the time period over which the effects of the merger are predicted? For example, we now evaluate the merger in terms of its short-term (one or two years) effect on prices. Are you saying that such an approach is often misleading because firms may not choose the short-run profit maximizing price because of long run considerations? If so, how do you identify the potency of that long-run constraint?

SCHEFFMAN: I am talking about something different. Using scanner data we are estimating extremely short-run elasticities. Brand managers probably do not act in their pricing decisions on such short-run elasticities. The issue is: what is the relevant elasticity (in time and other dimensions) that governs brand managers' pricing decisions?

ANTITRUST SOURCE: You have expressed skepticism about the role of unilateral effects in merger analysis. Would you support amending the Guidelines to eliminate the section on unilateral effects or to revise it in some manner?

SCHEFFMAN: I have expressed skepticism of the intensity of use of unilateral effects theories in mergers (at the expense of coordinated interaction theories) and some of the aspects of the application of unilateral effects analyses in some contexts. We hope to put out more guidance on this, beginning in the first half of next year.

AUDIENCE QUESTION: What is your criteria for evaluating efficiency defenses? From an evidentiary standpoint, what's a minimally acceptable efficiency defense?

SCHEFFMAN: The agencies spoke with some clarity in the 1997 Guidelines. Again, I cannot speak for the Commission. However, I think it is fair to say that efficiencies analysis is still evolving. One of the things we are doing is looking at what parties have actually been doing in response to the 1997 Guidelines, and how we have responded to their efficiency arguments and submissions. Our work here is at a very early stage. Of course, we've also litigated efficiencies in some cases. As a matter of economics, my opinion is that I think the approach articulated publicly by the Commission in the past is too narrow—we should be thinking more broadly as to potential sources of credible efficiencies. Chairman Muris took this position in a law review article [Timothy J. Muris, *The Government and Merger Efficiencies: Still Hostile After All These Years*, 7 Geo. Mason L. Rev. 729 (1999)]. My review of a lot of mergers and the literature on mergers leads me to conclude that, for example, increasing sales is probably a more important driver of mergers, on average, than reducing costs. This motivation sometimes gets somewhat disguised because of perceptions that antitrust review will look dimly on objectives that include increased market share. In any event, we have the 1997 Guidelines and one thing we are going to do of course is to analyze efficiencies as laid out in the Guidelines. Nonetheless, the Bureau of Economics and I have some ability to forward analyses and recommendations to the Commission that encompass a broader, what I what call a more sophisticated economics-based and business strategy approach to efficiencies. And we have five Commissioners who are the decision makers. In any event, supportable facts are absolutely essential for a credible efficiency argument.

But at a more general level, in my view the most important thing parties on the outside need to do is to explain from the beginning why their deal is taking place. What is the deal about? Is there a plausible business justification? What is the support for that business justification, and what are the potential competitive implications? And then, of course, are there explicit efficiencies with factual support? But remember, we're prosecutors. So our view is, what's wrong with your deal? That's our job. That makes it particularly important for you to highlight whatever is good about your deal in terms of business justification, efficiencies, potential impact on competition, etc., even though you can't necessarily quantify it in the sense of our 1997 Guidelines. This provides a different perspective that this deal might actually make good business sense and have the possibility of strengthening competition and benefiting consumers. However, I caution you to have plausible arguments that are as much as possible based in facts.

In my view the most important thing parties on the outside need to do is to explain from the beginning why their deal is taking place. What is the deal about? Is there a plausible business justification? What is the support for that business justification, and what are the potential competitive implications? And then, of course, are there explicit efficiencies with factual support?

I have spent over twelve years as a business strategy MBA professor and consultant. I think I have some ability to assess the strategic merits of a proposed transaction. So, of course, I am interested in learning about the strategic motivations and projected effects of a transaction. However, in my view, such general themes and arguments are not going to lead anyone to decide they're not going to sue you, if we think the deal is clearly anticompetitive. But in a situation where we're weighing a very complicated, ambiguous situation, convincing us that in a business and economic sense the deal is probably "pretty good," absent antitrust concerns, is a lot better than a vacuum where we just say, well, if we block this deal . . . so what? Of course, the Commission does not attempt to block transactions without a solid basis. I'm not saying that there's a "balancing" here. If the deal is anticompetitive, we're going to sue (although, remember again, I am not the decision maker). However, a lot of deals that we investigate are pretty complicated and, in a "close call," the strategic and economic purposes and implications of a proposed deal can make a difference.

So I'd urge everyone to think about what their deal is about and then see if it does have a plausible business purpose that perhaps also has the potential to be procompetitive. Of course, there is not much credibility from producing this from whole cloth which is not reflected in company documents. On efficiencies as analyzed under the antitrust laws, as discussed above, in the Bureau of Economics, we're trying to examine past practices to look and see what parties have done since the 1997 Guidelines and study what we've done about it. We have limited resources, but we're thinking about that.

In investigations, we're going to try and engage people in meaningful discussion if they put forward an apparently credible efficiency argument. For those companies that regularly appear at the agencies with mergers ("merger recidivists"), I'm very interested in asking them what actually happened in the merger that we investigated a couple of years ago? Why don't you tell us about it? You made these claims that these things were going to happen. Tell us what happened. Show us whether what you claimed to do actually happened or not. When I was on the outside, I advocated that my clients do that when we had been in with another deal in the recent past. Why don't we show them what we actually did, so that we'll have credibility because we could show that we actually did what we said we would do?

My own opinion, and this is supported by both academic work and M&A consulting, is that the key to a successful merger is implementation. A past track record of actually achieving merger benefits in my opinion provides some support for merger benefits. Furthermore, I am personally interested in what specific plans you have to actually carry out what you claim you are going to do. My opinion as a business strategy professor, is that if you do not have explicit measurable goals and targets and timetables with accountability, "it" is probably not going to happen.

To sum up, we are thinking about the efficiency issue, but more in terms of understanding what parties are doing in response to the 1997 Guidelines and how to analyze efficiencies. There's no change in policy. But explicit consideration of efficiencies is still pretty new. I think what we're going to do is understand better what the '97 change meant and how it has played out. What sorts of things are we getting from the outside? How are we dealing with them? Then, we hope, maybe sometime next year, we'll be able to report what we learned.

NELSON: I have a follow up question on efficiencies: Let's assume that you may be able to show that the merger will lead to significant cost savings. In concentrated industries where an efficiencies defense may be particularly important, there's often a debate with the staff about whether there's significant pass-through of the efficiencies to consumers. There also may be a debate over whether the efficiencies are "merger specific." As a former marketing professor, just in terms of the "merger specificity" issue, assume that the acquiring firm thinks it has particularly strong managerial skills and expects that it will be able to eliminate organizational slack in the acquired firm so that it can manage the acquired assets better. Some lawyers will argue that this type of efficiency is not merger-specific because anybody who's a smart entrepreneur can take out organizational slack. On the other hand, it may be that the organizational slack has been present for a decade, nobody has attempted to remove the slack, and relatively few firms are able to identify the slack and eliminate it. Is this type of cost saving a merger-specific efficiency? Should this type of efficiency be identified in presentations to the FTC?

SCHEFFMAN: It is my opinion that any credible efficiency that you can back up should be put forward. However, you had better be able to back it up because there is one thing worse than saying nothing and that's saying something that we find out isn't true. And then you're in a big hole rather than just being at zero. The way the agencies, the Pitofsky FTC in particular, have discussed efficiencies in public pronouncements, it appears that what you're talking about would not generally have been counted as merger-specific and it wouldn't have been "weighed" by the Pitofsky Commission, at least according to public pronouncements of senior Commission officials. (B.E. is doing some work to get a better understanding of how efficiency considerations figured in actual decisions).

As an economist, that isn't the policy I would choose. However, remember that the 1997 Guidelines don't say that you can only put forward what is summarized in the Guidelines. You can put forward whatever you want. We have a number of decision makers who weigh things: the five Commissioners, with input from BE and BC staff, and Joe Simons and myself. Different people may look at things somewhat differently. I'd say, again, there's no change in policy. You can see in Bob Pitofsky's writings that he was not "anti-efficiencies." But the policy doesn't say that you can't make whatever factually-supported case you want, to see whether you can influence any decision maker that a certain argument should be weighed. But, again, I think a situation in which we are "balancing" a merger that we are pretty sure is anticompetitive against efficiencies, in my opinion, is going to be extremely rare. However, where we think there really are substantial efficiencies, someone may conclude that because of the efficiencies and a lot of other things, the merger is probably not likely to be anticompetitive. From an economics perspective, I think it would be very rare if you have a situation where you thought this was a really efficient transaction, was going to strengthen competition, and prices were going to go up. I don't know. I have not seen such a situation, so I don't think that this balancing is really empirically very important. However, efficiencies can be very important because some cases are close calls and then lots of things come into play. But again, remember, I'm not a decision maker—the Commissioners are the ones who decide these matters.

AUDIENCE QUESTION: Can you give us your thoughts on how you evaluate fixed cost versus variable cost efficiencies?

SCHEFFMAN: What we will do, you can be sure, as in anything the Bureau of Economics sends up to the Commission, will begin by following the approach laid out in the Guidelines. Under *simple* economic arguments, variable cost reductions would generally be counted to be more important. However, fixed costs aren't unimportant. It would depend on the situation. What's the incentive of the party that is gaining the efficiencies to expand output or to reduce price. As a matter of simple economics, that's most closely related, generally, to variable cost. However, it certainly can, in some situations, be related to fixed cost. (Through, for example, the effect of ongoing fixed cost reductions on the rate of return on incremental investments).

AUDIENCE QUESTION: Joe Simons said something about looking at more vertical cases and also about the issue of raising rivals' costs. Are the vertical cases that you're interested in things where there's already kind of a horizontal problem, since the vertical things typically are not problematic?

SCHEFFMAN: As Joe indicated, we do have some investigations that have some significant vertical issues that are part of the investigation. I think that in terms of both law and economics, a vertical case is more likely to be a good case if it has a significant horizontal component. There wasn't a lot of so-called vertical enforcement over the last ten years. There were cases where vertical issues were important parts of the case. That was true in the 1980s, also. We just did not flag them. Again, I don't see any significant change. We are looking at potential cases that have a vertical component that are probably good cases.

ANTITRUST SOURCE: Regarding evaluations of consummated mergers, does the Bureau of Economics intend to conduct any concerted review of mergers (1) generally, as to whether claimed efficiencies were achieved, and (2) as to what the overall impact mergers have had on the market structure and performance indicators? If so, would such a review be focused on specific types of mergers, e.g., hospital mergers?

SCHEFFMAN: We are devoting some resources to review of mergers, both as to competitive outcomes and efficiencies. We are interested in trying to assess the effects of mergers of hospitals.

ANTITRUST SOURCE: Under what circumstances might such a review warrant reopening a merger investigation?

SCHEFFMAN: That would be a decision by the lawyers.

NELSON: Our discussion has largely focused on issues relating to the parties that are being investigated by the FTC. However, the FTC is *if you're coming in as complaining competitor in a merger, you have a significant burden in that case to convince the economists that you really have something, because the usual economic presumption is if a competitor does not like the transaction it's because it's going to be pro-competitive, not anticompetitive.*

also contacted by firms that want to complain. Do most of your comments today apply to people filing complaints, or is there something additional that you think someone who is going to go in and lodge a complaint either in a monopolization case or in a merger case should know?

SCHEFFMAN: I've never done this on the outside, but if you're coming in as complaining competitor in a merger, you have a significant burden in that case to convince the economists that you really have something, because the usual economic presumption is if a competitor does not like the transaction it's because it's going to be pro-competitive, not anticompetitive. We've had that presumption (at least the economists) for twenty years, so you have a real burden in that case to show us that you've got some real facts. Of course that is a rebuttable presumption (after all, I did co-author "Raising Rivals' Costs").

In the past I have come into the Commission a number of times for complaining parties (but not competitors), to try and get the Commission to act on something that my client was concerned about. My opinion is that you've got to really give us something in terms of facts and, in some situations, other things. For example, in some matters it's probably a good idea to try to give us some help with the law, if it's an area of the law that's not so clear. IP issues, for example, often make for very tricky issues, given the state of the law. You should think about how you can help beyond alerting us to your concern. The way you can really help is to provide us with some of the investigation that we would normally do—the facts and legal analysis, if that's important.

NELSON: There are some structural characteristics of the Bureau of Economics in which I thought some people might be interested: How many economists do you have now? Is the staff going to grow or shrink? Is there going to be any sort of reallocation of staff between mergers and other efforts? For example, when we were both at the Commission together, there was a fair amount of intervention work, such as testifying at the ITC or other places about consumers' interest. Is there going to be an increase in this type of competition advocacy work? Generally, how are the Bureau of Economics's resources going to be allocated and are they going to grow?

SCHEFFMAN: To begin with, we already have a really, really fine staff. They are a very solid group of economists, as some of you who have been there know. There are a number of people, probably twenty-five or so, who were in the Bureau back when I was there in the '80's, and maybe more than that, as well as some fresh, new blood—very bright young folks. We really have a very good group of people who work very well together. When I got to the Commission, the Bureau of Economics was around 200 people. Now it's 100. That's about what it was when I left in 1988. And the Commission has grown since. That's put a lot of strain on us. There are many more "hot" investigations going on at any one time now than in the 1980s. It's really interesting because there's no controversy at all anymore with the lawyers on the antitrust side whether economists are needed on antitrust investigations and litigation. That used to be what the fight was about in the '80's—what do we need you folks for? There's no fight about it now. They know they need us. And so there's really much more demand for our services than before and we're a lot busier.

However, we're a lot more efficient. In the 1980s we were still trying to figure out the Guidelines and find our way. We know a lot better what we're doing now, so we can be, and are, much more efficient. But we're actually stretched very thin. So we allocate resources so that we contribute most when economics has an important contribution. It's a difficult resource allocation problem, particularly since the Commission has a very active nonmerger enforcement program. But we're working much more closely with the lawyers.

In a way, in the 1980s, we were duplicating a lot of stuff that the lawyers were doing, collecting deposition and documentary evidence, etc. because we thought that the evidence actually showed something different than what the lawyers thought it did. We're not doing these duplicative efforts so much anymore. We don't have time. We're working much more closely with the lawyers, so we can allocate our resources better. But we have a lot of demands on our time.

There's much more burden on the outside parties than there was years ago. We have to do our job and you have to do your job. It's not so much a "mystery" like it was in the 1980s, where no one knew what we were doing because we were "making it up" (increasing our understanding of the Guidelines and how to do economics-based merger investigations) as we went along. We are much more settled in our approach to merger investigations than we were then.

But you've got to do your part. That's why I'm going to meet with the parties as early as possible, trying to clarify our needs for information and for analyses and to identify our issues. We've got very limited resources. In the 1980s, the Bureau of Economics in a lot of ways was doing the work for the outsiders because the outsiders didn't know what to do. We weren't trying to make the case for the outsiders. Rather, we were trying to develop the evidence because the economics suggested that the parties, if they knew what they were doing and had good economists, would do it. We don't have the resources to do this anymore. Often these days we are going to ask you—have your economists or business people develop these data and analyses and get it to us soon enough that we can check it thoroughly and think it through.

So there's much more burden on the outside parties, and that's why it's much more important that we be transparent and say, "This is what we're interested in. What have you got on this?" Because we have scarce resources.

NELSON: There sometimes is a feeling in FTC investigations that the FTC staff and the outside parties are "ships passing in the night." For example, lawyers periodically said, "Gee, the FTC economist who attended the meeting may not have understood our point. You should give him a call and sort through the issue with him to make sure he understood the argument and factual support." At times, there have been restrictions on conversations that an FTC economist can have with outside parties—either outside economists working on the matter or outside lawyers. Are those restrictions still in place or is the FTC more open? Can outside economists and FTC economists just pick up the phone and talk?

SCHEFFMAN: No, I think we'd be very careful of picking up the phone and talking to outside parties. We have to clear that with our lawyers. I've been a litigation economist—an expert witness—for a long time. I understand that we don't want to have stuff pop up where economists speak to economists like economists do outside a litigation environment. We have to be careful how we do it, but I do think that after touching the legal bases, that we can be more transparent and share data and have more discussion, subject to protecting our legal prerogatives.

NELSON: How should outsiders go about identifying what arguments the FTC has in mind?

SCHEFFMAN: One obvious issue is that we know a lot of things that you don't know. We talked to your customers, and your business people very often don't know what your customers and your competitors are saying. But, I think the biggest problem with "outsiders" not understanding what we are grappling with is "groupthink." At some point, back early on, if you did a good job, you identified the potential issues. Then you focus your attention on trying to make those issues "disappear." In my experience, the outside parties often lose sight of the likelihood that there are genuine issues that they do not really have conclusive answers for, sometimes because people talked themselves into believing that they had an issue nailed, but did not, sometimes when further work might have actually nailed it. And we fairly often end up being concerned about something that probably was on your list of potential problem areas early on, but somehow got crossed off *your* list and you can't, anymore, even entertain the idea that that would be an issue. I always use my role as an economist, either inside or outside the agency, (and outside that wasn't always very popular with the lawyer's client), to be a devil's advocate and say maybe they're thinking about this and what do we have to say about this? People don't like to hear that when you get far into the investigation. Put differently, I think that a real problem in advocacy is getting locked into your own view and not realizing we're not stupid. We're actually, on average, very good at what we do. But we don't know some stuff you know and we do know a lot of stuff you don't know. And we have a larger perspective for you to try and think about—what we might be thinking about and why.

NELSON: Another thing that has varied over the years has been the extent to which staff economists are involved in informal interviews and depositions. At various times, there have been at least rumors that there is sort of a gag order on the economists that limits their ability to just step up and ask any questions that are on their minds. Under FTC rules, as I understand them, economists can cross-examine even in a formal deposition and before an ALJ. Are economists always free to ask anything they want, or do they typically have to ask their questions through an attorney?

SCHEFFMAN: Depositions require a lot of skill. Most of our lawyers do not want to have the economist ask the questions. I can't argue with that. I do argue if our lawyers don't want to somehow get the information that we think is important. But they run the deposition. We don't even let our new lawyers do depositions. They have to be here awhile and be trained. In any event, I don't think this issue is of much importance.

NELSON: What I thought was a major change in FTC policy under the Pitofsky/Baer regime was a change in what it took to settle merger cases. It became harder to close the merger before finding a buyer for assets that had to be divested—there was more pressure to find an up-front buyer. Is there any thinking that the FTC's policies with respect to fixing mergers might change or is it likely that you will follow the policies of your predecessors?

SCHEFFMAN: Well, again, I cannot speak for the Commission. I think Joe Simons said something about merger remedies at the FTC Committee Brownbag last week. In my opinion, an up-front buyer has some plusses and minuses. The main plus is that you can evaluate the buyer from the beginning and determine whether you can effect a suitable fix. On the other hand, the up-front buyer situation often limits information we want to have about potential alternatives, the "true" requirements of the up-front buyer to be fully competitive, etc. So again, in my opinion I don't think the policy is that we always want an up-front buyer, but Joe Simons will speak more clearly on that. But I do think that all of us in the current senior management think that it's taken too long in the past to resolve things. I think both Joe Simons and I don't like things to linger on. We do our work, we make decisions, and we like to get a matter resolved. We think that the Chairman has a lot of confidence in us and vice versa. But we have five decision makers we work for and we're not the ultimate decision maker. Only the Commissioners can determine the ultimate resolution, and this can sometimes get complicated. ●