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WELFARE STANDARDS AND MERGER ANALYSIS REVISITED

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In 2006, Competition Policy International published my article "Welfare Standards and Merger Analysis: Why Not the Best?" in its Fall issue. In the article, I presented arguments for employing a total, rather than a consumer welfare standard for evaluating and determining whether to challenge proposed mergers. Prior to the article being accepted, I learned that its publication would likely be contingent upon the editors finding an author willing to take an opposing side of the issue. Appropriately, they wanted to provide the journal's readership with competing views on a relevant and controversial topic.

Although I was very much hoping to see my article in print, my pleasure in learning of its acceptance was short-lived. This is because the journal had managed not only to find one outstanding author to write a dissenting piece, but two. The co-authors, to my dismay, were Joe Farrell and Mike Katz. These two exceptional economists are not only ones for whom I have the greatest respect and admiration, but also former bosses of mine who served with distinction as chief economists at the Antitrust Division of the Justice Department.

Fortunately, from my perspective at least, the companion piece written by Joe and Mike was less a frontal assault on my primary premises and analytics, and more a thoughtful analysis of a broader issue: how the goal of maximizing total welfare might be better served by having decision makers employ a consumer welfare standard when evaluating mergers.[1]

Six years later: What more is there to say?

Since the time the article was published, it is hard to think of major theoretical advances that merit serious reconsideration of the core arguments. With one possible exception, discussed below, the issues and our knowledge of them are much the same now as

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* This article was written while Ken Heyer was Chief, Competition Policy Section, Antitrust Division of the United States Department of Justice. In June of this year Ken joined the Federal Trade Commission as Deputy Director for Antitrust in its Bureau of Economics. The views expressed herein are his alone, and do not purport to represent those of either the Department of Justice or the Federal Trade Commission.

1 Their finding flows from an analysis of how the competition authority's standard for challenging mergers may affect the universe of mergers that end up being proposed. When faced with a decision maker who expressly employs a consumer rather than a total welfare standard, the mergers proposed by profit-maximizing firms might, somewhat counter-intuitively, do a better job of maximizing total welfare.

The welfare effects from enhanced buyer power are readily analyzed under a total welfare standard. On what basis would mergers that enhance buyer power be challenged under a consumer welfare standard?

they were then. Still, there have been some relevant developments worth noting. In particular, the Antitrust Division, jointly with the Federal Trade Commission, issued revised Horizontal Merger Guidelines in 2010.[2] These include some new discussion of how the Agencies may deal with specific fact patterns. In particular, the revised Guidelines' discussion of mergers of competing buyers and the potential these may have to enhance monopsony power bears on the welfare standard likely to be applied.[3]

A "consumer welfare standard" focuses on the effects that a merger is likely to have on those who purchase the relevant product (or service). In cases where those proposing to merge are substantial buyers, however, the competitive concern is that those potentially affected adversely are sellers, not purchasers. Indeed, in such cases it is the customer who is likely to benefit from a diminution in competition. The welfare effects from enhanced buyer power are readily analyzed under a total welfare standard. On what basis would mergers that enhance buyer power be challenged under a consumer welfare standard?

One answer is that the exercise of buyer power by an intermediate firm may, by depressing the price that sellers receive, lower total output in the marketplace. Doing so would, in turn, harm final consumers, and it is the welfare of final consumers that a consumer welfare standard is designed to protect.

This line of argument is correct as far as it goes, but it goes only so far. For one thing, if sellers are currently exercising market power, enhanced power on the buying side may (but will not invariably) result in greater output for final consumers if the prices of sellers are moved closer to the competitive level. In addition, even where at-risk sellers are exercising no market power pre-merger, a merger-generated exercise of monopsony power will not necessarily lower the total quantity supplied to, or raise the prices paid by, final consumers. This can easily be the case when buying markets are relatively local, but selling markets are much broader.

Consider a hypothetical merger to monopsony in the purchase of some agricultural or mineral product. The merger might, for example, involve two railroads who compete to transport goods from the production site, or two grain elevators who aggregate grain and store it, or any two intermediate purchasers or processors whose facilities happen to be located especially close to the potentially at-risk producers. If the prices at which the relevant product is sold to

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[2] U.S. Dep't of Justice & Federal Trade Commission, Horizontal Merger Guidelines (2010), *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf.

[3] *Id.*, at Section 12.

final consumers are set in a world market, final consumers are protected from an exercise of market power by the merged firm. Nevertheless, those from whom the merging parties purchase--perhaps farmers in the Midwest—may be at risk.[4]

Despite such predictions, there remains for many an open empirical question as to whether firms actually do treat fixed cost savings according to the predictions of microeconomic theory

Notably, the revised Guidelines contain an explicit statement that expresses concern over exactly this possibility. *Example 24* in Section 12 "Mergers of Competing Buyers" depicts a hypothetical merger in which monopsony power may be enhanced—and be of concern to the competition authority—even where there will be no harm to final consumers of the product. "These [harmful] effects," it states in relevant part, "can arise even if the merger will not lead to any increase in the price charged by the merged firm for its output."

It is not obvious why such mergers would be objectionable under a consumer, rather than a total, welfare standard.

Finally, in my original article I gave as one reason for adopting a total welfare standard the difficulties competition agencies can face in determining the extent to which claimed efficiencies involve incremental cost savings or fixed cost savings (the second of which, according to conventional microeconomic theory, would not be expected to lower prices). Despite such predictions, there remains for many an open empirical question as to whether firms actually do treat fixed cost savings according to the predictions of microeconomic theory.

I attended a year or two ago one of the many panel discussions that have sprung up in the wake of the growing interest in behavioral economics. While there, I had occasion to speak with one of the panelists, Professor Steve Salop, about some of the issues it raised for antitrust policy. We speculated as to how, when evaluating merging parties' claims of demonstrable and merger-specific *fixed* cost savings, the competition authorities would respond to strong evidence that the firms in their normal business practice actually do set prices partly as a function of the level of their fixed costs. If, for whatever combination of reasons, they behave in this way, it would imply that even fixed cost savings—those entirely acceptable as a defense under a total welfare standard—might in part help firms satisfy a consumer welfare standard as well.

The jury is still out on whether evidence will ever confirm persuasively this possibility. Should it do so, however, supporters of a total welfare standard would not be displeased. After all, it is not only the welfare of the economy's entrepreneurs, investors and manufacturers that we believe should be valued. Consumers are people too.

4 If those selling to the merging firms face an upward sloping marginal cost curve of producing and selling their product, and supply from other sources is elastic at current prices, monopsony power could profitably be exercised over the former despite the fact that their reduced output would be completely offset by greater output from others.