WHY DOES THE CONSUMER WELFARE STANDARD WORK? MATCHING METHODS TO MARKETS

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I. ECONOMIC PRESUMPTIONS DRIVE LEGAL PRESUMPTIONS

Much of the competition policy discussion today centers around goals of antitrust. As recently as 2013, a symposium on the goals of antitrust that appeared in the Fordham Law Review suggested that antitrust goals were economic ones.[2] Anyone who thought otherwise was on the fringe and discounted both academically and within policy circles.

Yet only a few years later, the goals of antitrust once again became the subject of debate due to a concatenation of events. Growing populism on both the left and right in the United States and globally; a number of studies showing increased income inequality and increased concentration; digital transformations across industries that disrupt traditional ways of the organization of economic activity and life more generally; and the lingering effects of the Great Recession all have caused people in policy settings, some antitrust authorities, and some scholars to question whether or not an economics-based goal (which for shorthand we call the consumer welfare standard) is relevant.

We suggest that consumer welfare works as the method of analysis for antitrust law. Unlike critiques that treat consumer welfare as a caricature within a simplistic early-1970s framework of "Chicago School" economics, we suggest that consumer welfare as understood today is flexible to changes in economic thinking. Nor are we alone in such an understanding. As the U.S. Supreme Court stated in 2015, "We have therefore felt relatively free to revise our legal analysis as economic understanding evolves and … to reverse antitrust precedents that misperceived a practice's competitive consequences."[3]

Antitrust analysis in the United States is shaped by judges rather than by a complex statutory scheme. The primary enabling statute, the Sherman Act, is relatively short and vague. Thus, to understand the use of economic analysis and why it works in an antitrust context, we must first begin with an understanding of the nature of antitrust law and how antitrust law works.

Antitrust law's general application created a common-law-like development for antitrust case law. Yet, antitrust common law development is dissimilar to many other fields of law in that *stare decisis* plays a much smaller role in antitrust.[4] Thus, by design, antitrust law doctrines can shift as the understanding of certain economic theories become more established and developed.

2 Barak Orbach, *Foreword: Antitrust's Pursuit of Purpose*, 81 Fordham L. Rev. 8151 (2013) (providing an overview of the symposium).

3 *Kimble v. Marvel,* 135 S. Ct. 2401, 2412 - 13 (2015). This approach far predates a "Chicago" turn in the courts. See e.g. *Appalachian Coals, Inc. v. United States*, 288 U.S. 344, 359-360 (1933).

4 D. Daniel Sokol, "Rethinking the Efficiency of the Common Law," *Notre Dame L. Rev.* (forthcoming). Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3328025.

Changes in economics lead to different legal presumptions. For example, when the economic understanding of an issue is unclear, *per se* legal rules may make more sense because the "*per se* rule, treating categories of restraints as necessarily illegal, eliminates the need to study the reasonableness of an individual restraint in light of the real market forces at work."[5] When shifts occur in economic understanding, this may lead to a reevaluation of the legal presumption to incorporate the ways that certain behavior may require a more nuanced treatment under the rule of reason.[6]

Such Type II errors were corrected in particular for certain types of vertical restraints such as minimum resale prince maintenance, maximum resale price maintenance, and territorial restrictions because of a better understanding of the economics underlying these practices. In other settings, changes in how economic insights view competitive harm may suggest the need for legal presumptions that are more receptive to theories of harm, such as most-favored-nation clauses ("MFNs") or health care mergers, where there may have been a number of Type I errors. The critical point is that to ensure against both types of errors, the economic analysis needs to be done correctly.

If there is a non-economics standard, some sort of fairness consideration takes the place of economics. What is "fair" is often indeterminate. For those of us who are parents of more than one child and/or who have siblings of our own, what is fair is best understood as those situations that benefit me, whereas what is unfair would be those situations that benefit someone else.

Because economic analysis allows for more precision than fairness, we believe that it is important to highlight examples that show how economic analysis has shifted over time in ways that both promote enforcement and limit enforcement. All too often, the populist narratives of antitrust overlook such changes in economic thinking, where new theories and approaches can be applied to new settings.

II. "BRING THE BEST EVIDENCE": MAPPING THEORY TO PRACTICAL REALITIES IN MERGER REVIEWS

Examining the critical role for economic evidence in merger reviews provides some illustrative insights highlighting the importance of mapping theory to practical realities. Economic reasoning provided the foundation for the courts' adoption of the consumer welfare standard as the framework through which to evaluate antitrust enforcement, and it has also provided the tools used to apply the standard to specific markets.

In merger reviews, economics provides a diverse set of tools and methodologies that can be used to examine the extent to which a proposed merger is expected to harm consumers and for assessing such harm in the context of dynamic competition. Economists can use market data, survey data, business documents, and natural experiments to assess market concentration and current and future diversion rates, and to forecast price and quantity outcomes to evaluate the competitive effects of any proposed merger.

Yet, when courts use the wrong analytical tools, rely upon incomplete or inaccurate inputs or assumptions, or incorrectly apply the correct tools, their conclusions will be flawed. In such cases, the courts will not be able to offer accurate predictions about the harm or benefit that could come from a proposed merger.

In this section, we discuss several examples in which application of the appropriate economic methodology made the competitive impact of a merger clear, while misapplication of economic thinking can lead to a different, incorrect conclusion.

An examination of the evolution of merger review in different markets over the last 20 years offers examples that illustrate the importance of using the right evidence and the right methodologies for each circumstance. Just because an analytical tool works for evaluating a specific merger in a specific industry, that does not mean the same tool will provide evidence that is helpful for evaluating another merger in a different industry.

In fact, even within a given industry, market dynamics can render previously insightful economic analyses obsolete. For instance, antitrust analysis based on spatial competition among brick-and-mortar retailers may not capture the intensity of ongoing price competition post-merger as well as it did prior to the arrival of internet suppliers who can ship goods to customers regardless of store locations.

5 *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 886 (2007).

6 William Breit, "Resale Price Maintenance: What Do Economists Know and When Did They Know It?," *Journal of Institutional and Theoretical Economics,* Vol. 147, pp. 72-90 (1991).

As economists develop improved methodologies and as industries evolve, so too must antitrust authorities adapt their methodologies. And to their credit, they have. For instance, after the 1990s, the courts changed their approach to hospital merger analysis after post-merger reviews demonstrated that these mergers were consistently increasing health care costs.[7] Antitrust authorities, moreover, have proved open to considering new methodologies that can improve their ability to predict the impacts of mergers. For example, in some instances, courts have accepted appropriately designed consumer surveys to lend insights in contexts where the publicly available data are inadequate.[8]

With so many kinds of evidence at hand, the right economic analysis to evaluate a given merger must be tailored to the specific competitive context. It must take into account the major drivers of price in a given market, and it must be able to predict the competitive impact of consolidation in that market.

A. Matching Methods to Market Context: Lessons from a History of Hospital Mergers

The consumer welfare standard works as long as the right consumers are identified. As the Federal Trade Commission ("FTC") recognized after a string of unsuccessful attempts to block hospital mergers in the 1990s, the methodology used to evaluate expected outcomes must be appropriately matched to the market if it is to be effective.

In earlier merger reviews, the merging parties adopted from manufacturing industries an Elzinga-Hogarty ("E-H") analysis of inflows and outflows to identify broad "relevant" geographic markets.[9] If there were substantial inflows and outflows of goods across geographies, so the E-H logic went, then it would be easy for customers to switch to different sellers if the merging suppliers attempted to raise prices.

However, the E-H approach had been developed to describe the flow of manufactured goods into and out of a region, not the flow of people seeking health care services. By assuming that the distribution of patients could be modeled based on theories and methodologies established for manufactured goods in evaluating market concentration, the economics applied in these matters missed a crucial economic point – namely, that just because some individual patients were willing to travel long distances for specific hospital services, it did not imply that other patients would be willing to travel further if prices at the merging hospitals increased.

Treatment choices are determined based on a series of factors, and price is likely to be of marginal, if any, significance to patients, given the presence of insurance coverage and co-pays. Individual patients choosing medical care will rely on very individualized criteria, influenced largely by the type of service being sought. Some patients will seek convenience, preferring to go to a hospital that is close to home. Others will make decisions based on the availability of specialized services or coverage within a particular plan's network, the state of a hospital's facilities, reputation, or a range of other factors.

Given that many patients are protected from the full marginal cost of health care service, price is likely to play a minimal part in their decision making. In fact, data from post-merger markets showed that mergers approved under the E-H approach ultimately led to higher prices.

In actuality, the most price-sensitive "consumer" following a proposed merger of health care service providers (such as hospital systems or physician groups) is more likely to be the payers for those services, which are the insurers. In the health care industry, the price for the same service, procedure, or product can differ substantially across markets, across providers, and even for the same provider in relation to different health insurers. Consequently, concentration in both the insurer market and the provider market may be relevant when modeling the effects of a merger of two hospitals.

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7 David Dranove & Andrew Sfekas, "The Revolution in Health Care Antitrust: New Methods and Provocative Implications," *The Milbank Quarterly,* Vol. 87, pp. 607-632 (2009).

8 Federal Communications Commission and Department of Justice approval for AT&T acquisition of DirectTV (2015); French Competition Authority approval of Fnac acquisition of Darty (2016); and Federal Trade Commission approval of WEX acquisition of EFS (2016).

9 Kenneth G. Elzinga & Thomas F. Hogarty, "The Problem of Geographic Market Delineation in Antimerger Suits," *Antitrust Bulletin*, Vol. 18, pp. 45-81 (1973); Kenneth G. Elzinga & Thomas F. Hogarty, "The Problem of Geographic Market Delineation Revisited: The Case of Coal," *Antitrust Bulletin*, Vol. 23, Pp. 1-18 (1978).

Eventually, a different model was proposed in hospital mergers that accounted for this two-stage model of competition, where hospitals first negotiate with insurers, and only subsequently compete for patients.[10] When the FTC started examining hospitals' ability to exercise market power over insurers, instead of focusing only on the end "consumer" (the patients), the FTC found that it was able to model competitive effects more accurately and construct arguments that reflected market structure and dynamics more effectively.

B. Natural Experiments: Staples/Office Depot I

In other instances, long-standing rules of thumb are being reevaluated for their appropriate – or not – application in a given circumstance. In 1997, the U.S. District Court for the District of Columbia rejected a proposed merger between Staples and Office Depot, two office supply "superstores," when the results from a natural experiment justified a narrower market definition.[11] At the time, Staples and Office Depot together controlled a mere 5.5 percent of the office products market based on sales data from any type of retail outlet.

In a traditional assessment of market concentration, that level would be below the threshold under the Horizontal Merger Guidelines that would justify a request to block the merger. However, upon closer examination, the FTC identified data and outcomes that suggested that a narrower market definition was warranted. Specifically, the FTC evaluated real-world market data related to pricing in sub-segments of retail outlets. When available, assessments of natural experiments such as this one can be useful in predicting outcomes post-merger.

At the time, only three superstores were in the market: Staples, Office Depot, and OfficeMax. Given geographic variation in the presence of these competitors, the FTC compared Staples' prices in geographic markets where Staples was the only office supply superstore to its prices in geographic markets where Staples competed with one or both of the other two superstores. It found that when Staples was the only office supply superstore in an area, its prices were an average of 13 percent higher than when all three chains were present. Similarly, Staples' prices were higher in regions where it only competed with OfficeMax than where it competed with both OfficeMax and Office Depot.

This evidence supported a narrower market definition that included only office supplies sold through office supply superstores, not through any other retail outlet. Based on this analysis, the FTC successfully argued that, by reducing the number of competitors from three to two, a Staples/Office Depot merger would allow the combined firm to increase prices above their current levels. Thus, whereas a judge who only considered Staples' and Office Depot's small share of overall office supply sales might have allowed the merger, the data from the natural experiment provided the necessary evidence for the judge to block a merger that posed a risk of harm to consumers.

C. Competitive Realities, Efficiencies, and Consumer Benefits: Baby Foods

A few years later, the FTC faced another proposed merger that they argued was a 3-to-2 merger that would lead to anticompetitive effects, this time in the market for baby foods. Eight years after that, however, the FTC's own examination of the resulting competitive landscape cast doubt on the economic analysis underlying the decision.

In 2000, the second-largest baby food manufacturer in the United States, H.J. Heinz, agreed to acquire Milnot Holding Corp., the parent of the third-largest baby food manufacturer, Beech-Nut. At the time, the U.S. market was dominated by Gerber, which claimed a 71-72 percent share. Heinz and Beech-Nut each claimed about 13 percent.

In its evaluation of the proposed merger, the FTC focused its arguments around the number of post-merger competitors, citing the circumstance that the proposed merger would reduce the number of meaningful competitors from three to two. Heinz and Beech-Nut countered by arguing that Gerber, in fact, was the dominant player, and neither of the other two firms by itself provided meaningful competitive constraints to Gerber. The parties presented evidence that the only way to introduce a viable competitor to Gerber would be to take advantage of the cost savings and economies of scale of a merged firm. Thus, instead of representing a 3-to-2 merger, the transaction actually would move the industry from a near-monopoly to something closer to a duopoly.

10 Recent discourse surrounding the evaluation of hospital mergers, accordingly, ignores patient flows, and instead focuses on how mergers affect bargaining leverage between hospitals and insurers. See, e.g. Dov Rothman & David Toniatti, "Comment on the Flaws in Using the Hypothetical Monopolist Test from the 'Payor Perspective,'" in Health Care Merger Cases, by Field, Fisher & Coglianese, *The Antitrust Source*, December 2017.

11 *Federal Trade Commission v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997).

The DC Circuit reversed a finding that allowed the merger based on an efficiencies rationale, thereby rejecting the proponents' position and blocking the merger. However, within a few years the FTC's own analysis showed that, while continuing to operate independently, Heinz's market share sank to a negligible 2 percent and Beech-Nut's declined to 11 or 12 percent.[12] At the same time, Gerber increased its already dominant share, despite raising its prices. In fact, by 2008 Gerber had nearly doubled the price difference it enjoyed over Beech-Nut, increasing from a difference of 32 cents for 16 ounces of baby food in 2000 to a difference of 61 cents by 2008. Despite this increase, Gerber was able to further expand its leading position in the marketplace.

The FTC's decision to block the Heinz/Beech-Nut merger did not help to maintain the market structure the FTC sought to protect, and the number of national mainstream baby food competitors fell from three to two as a result. Moreover, the decision prevented Heinz and Beech-Nut from potentially achieving sufficient economies of scale to develop into a substantial competitor to Gerber.[13] This result emphasizes the need to consider not just the number of competitors, but the nature of the competitive position of each and how a merger may actually increase competition even if the number of players is reduced.

D. Measuring Switching Behavior: Alternative Data Sources

Each of these prior cases emphasizes the critical need to understand the specific dynamics in a marketplace – how consumers make decisions, and how competition manifests itself – in order to accurately assess the expected competitive effects of any merger. For example, the experience with hospital mergers highlights the need for accurately identifying the underlying drivers of purchase decisions, particularly those that go beyond price to factors such as quality, relative performance, convenience, and availability. This can allow for better insights into market definition and future effects.

The history of the *Staples/Office Depot I* merger review shows how aggregated, widely tracked market shares for a product or service category may not accurately reflect the extent to which consumers consider products or distribution channels to be substitutes. Often, in retail industries, traditionally reported market shares are based on publicly available information such as scanner data, shipping manifests, or geographic proximity of brick-and-mortar stores. These type of data may not be fully representative of price competition in complex markets, especially those undergoing rapid change based on advances in technology and digital transformations. For example, fully understanding the competitive dynamics in digital and hybrid markets requires accounting for the interrelationships between online and offline distribution channels and retail outlets.

In 2016, the landmark merger decision by the French Competition Authority ("FCA") to approve the Fnac/Darty merger highlighted a growing recognition that both spatial and price competition are important to evaluating the potential competitive effects of a merger. Specifically, the FCA requested that the parties account for online sales in their assessment of local/regional market shares for electronic products across France. The FCA economists also evaluated third-party data to allocate both online and offline sales across regions to compute market shares and better understand the impact of the merger on local competitive conditions.

Consequently, despite what may have initially appeared to be an unacceptable consolidation of brick-and-mortar retailers, the agency recognized that consumer behavior had shifted and that online sales exerted significant competitive pressure, such that the market shares for physical stores were less relevant to the assessment of market dominance.

Fnac/Darty also shows how the use of alternative data sources can be incorporated by agencies and parties alike to illustrate shifting consumer preferences or to better model expected post-merger outcomes. In its review, the FCA first commissioned a survey of consumers to study their shopping habits. It then used the survey results, along with other evidence, to devise a weighted scoring method for calculating market shares and concentration measures, taking into account the relative competitive effects of online vs. offline sales. This methodology supplemented the FCA's analysis that ultimately led to its allowing the merger to proceed, conditional on the divestiture of a handful of stores.

Survey data were also presented in two recent telecommunications and media mergers in the United States (*DirecTV/AT&T* and *AT&T/Time Warner*). In each merger, primary research was used to examine outcomes under conditions that had not previously existed in the marketplace. In *DirecTV/AT&T*, the parties' expert conducted research using an online survey to illustrate that consumers perceived direct benefits from combining mobile and phone services with satellite services. In *AT&T/Time Warner*, the Department of Justice's ("DOJ's") expert explored the potential effects of a hypothetical blackout of major television stations resulting from a failed negotiation between content providers and distributors.

12 *Federal Trade Commission v. H.J. Heinz Co.*, 246 F.3d 708, 720–22 (D.C. Cir. 2001).

13 Viola Chen, "The Evolution of the Baby Food Industry, 2000 - 2008," *Journal of Competition Law & Economics,* Vol 6:2, pp. 423-442 (2009).

Interestingly, the courts' reliance on the two studies diverged considerably in the outcomes, with the DirecTV court accepting the results of the study, while the Time Warner court questioned the consistency of the survey results with real-world industry outcomes. In the latter case, the court rejected the survey methodology used, a decision which drew intense scrutiny afterwards. Regardless, the presentation of and reliance on such evidence emphasizes that primary research, such as surveys, should be considered in dynamic markets when existing data or prior natural experiments are insufficient for modeling competitive conditions post-merger.

III. CONCLUSION: FINDING THE RIGHT TOOLS FOR THE JOB

Antitrust law needs refinement – it always has and it always will. However, the consumer welfare standard is flexible enough to allow for the integration of economic understanding into workable legal rules, which in turn can better shape business behavior and risk taking. As we have shown, it is not enough to merely use economic analysis to address antitrust concerns. Rather, courts and antitrust authorities need to understand that certain economic tools are better for certain types of antitrust analysis. Furthermore, what has worked in the past needs to be continuously revisited, as better tools are developed that may suggest different ways of thinking about particular markets and competitive effects therein.

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