

The Role of Efficiencies in Telecommunications Merger Review

**Calvin S. Goldman, Q.C., Ilene Knable Gotts, and
Michael E. Piaskoski***

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*Calvin Goldman is a partner and the head of the Competition and Trade Law Group in the Toronto firm of Blake, Cassels & Graydon LLP, where his practice covers all aspects of Canadian competition law, including mergers and acquisitions. Michael Piaskoski is an associate at Blake, Cassels & Graydon LLP, where his practice encompasses competition law and telecommunications and broadcasting law. Ilene Gotts is an antitrust partner in the New York firm of Wachtell, Lipton, Rosen & Katz, where she focuses on mergers and acquisitions, including telecom transactions. The views expressed in this article (and any errors) are attributable solely to the authors, and not to the authors' firms or their firms' clients.

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I. INTRODUCTION

A. The Rise and Fall of the Telecom Industry

In the last decade, the telecommunications industry has experienced significant growth and consolidation in response to such external factors as deregulation and liberalization, technological change, and global market forces.¹ In addition, industry consolidation has occurred to achieve greater economies of scale and scope through more efficient deployment of network infrastructure.

Moreover, the desire of large, multinational customers to obtain fully integrated, end-to-end global telecommunications services from a single source (a “one-stop” telecom shopping experience, if you will) has created the impetus for telecom firms to offer multiservice broadband and seamless worldwide telecommunications networks. However, a major barrier to achieving this goal is the significant capital required to construct and

1. Between 1996 and 2001, more than twenty M&A transactions worth over \$20 billion took place in the telecom sector, including the two largest deals, the \$180 billion hostile bid successfully launched by Vodafone in November 1999 to acquire the Mannesmann conglomerate and build the largest mobile provider across Europe, and the \$160 billion merger between AOL and Time Warner. See Gilles Le Blanc & Howard Shelanski, *Merger Control and Remedies Policy in Telecommunications Mergers in the E.U. and U.S.* 9 (Aug. 2002) (preliminary draft) at <http://intel.si.umich.edu/tprc/papers/2002/122/TPRCTelecomMergers.pdf>.

deploy a global network and to develop innovations necessary to provide advanced services. In order to overcome this barrier, telecom companies typically adopt cooperative approaches to network building—such as mergers and acquisitions, joint ventures, legal partnerships, and strategic alliances (collectively referred to as “M&A”)—that combine complementary skills, technologies, and geographic reach, and achieve greater economies of scale and scope. As a telecom company expands its network and customer reach, its attractiveness as a potential global partner is also enhanced. A broader capacity and customer reach creates internal efficiencies that can result in lower costs for subscribers.

The telecom industry consisted traditionally of legally mandated monopolies that were regulated by governmental authorities. Technological advances, including the development of alternative infrastructures and new services, have dramatically altered the economics of telecom services and have made possible the potential for competition to replace regulation in at least part of the services provided. The deregulation of the industry during the last decade has allowed telecom firms to achieve economies of scale and scope by (1) expanding into new product or geographic markets or gaining market entry across traditional industry lines and (2) integrating network infrastructure and content. In a deregulated environment, telecom firms may seek to provide a “bundle” of products and services, particularly with the technological convergence of the telecom and cable industries.

New technologies also stimulate M&A activity. For example, the provision of broadband access services in the homes of consumers and the ability to combine content with transmission were key factors behind many telecommunications mergers. Further, the erosion of trade restrictions and other international regulatory barriers facilitated increased cross-border telecommunications activity as well as the number of mergers and joint ventures among international firms.

While rapid growth contributed to industry consolidation during the last decade, the recent downturn in the telecom industry may also result in further industry consolidation during the next several years. For example, in anticipation of a huge global demand for high-speed broadband transmission capacity, network owners and operators invested considerable capital in global fiber-optic networks only to discover that actual demand levels remained a fraction of built capacity. As a result, a glut of transmission capacity exists globally, leaving network owners and operators struggling to “fill their pipes.” These network assets are now prime for acquisition by the larger and more stable carriers seeking to expand their networks. Further, while deregulation efforts in the North American telecommunications industry were aimed at promoting and

facilitating competition in all areas, the state of real competition in some sectors remains questionable with many participants, including long-distance providers, competitive local exchange carriers (“CLECs”), and wireless providers, experiencing financial difficulties.² Again, the network assets of these companies may be seen as attractive to those companies seeking to expand their geographic reach or service offerings.

Finally, in Canada, the anticipated removal or relaxation of the foreign ownership restrictions relating to facilities-based telecom carriers and broadcasting distribution undertakings will provide further opportunities for international consolidation.³

2. Appendix B provides a partial list of telecommunications companies that have experienced economic difficulties in the past few years.

3. On April 28, 2003, following a month-long public hearing, the House of Commons Industry, Science, and Technology Committee issued its report entitled “Opening Canadian Communications to the World,” (the “Industry Report”) in which the Committee recommended that the Government of Canada prepare all necessary legislative changes to entirely remove the existing minimum Canadian ownership requirements applicable to telecommunications common carriers set out in the Canadian Telecommunications Act. In addition, the Committee recommended that the same changes be made to the foreign ownership restrictions applicable to broadcasting distribution undertakings (“BDUs”), which include cable companies and DTH (or DBS) satellite companies. STANDING COMM. ON INDUS., SCI., AND TECH., HOUSE OF COMMONS, OPENING CANADIAN COMMUNICATIONS TO THE WORLD (April 2003), available at <http://www.parl.gc.ca/InfoComDoc/37/2/INST/Studies/Reports/instrp03/instrp03-e.pdf>.

However, in a separate report prepared by the Standing Committee on Canadian Heritage entitled *Our Cultural Sovereignty: The Second Century of Canadian Broadcasting* (the “Heritage Report”), issued on June 11, 2003, that Committee recommended that the foreign ownership restrictions for all broadcasting entities, including BDUs, remain in place. STANDING COMM. ON CANADIAN HERITAGE, HOUSE OF COMMONS, OUR CULTURAL SOVEREIGNTY: THE SECOND CENTURY OF CANADIAN BROADCASTING 420-23 (June 11, 2003), available at <http://www.parl.gc.ca/InfocomDoc/bak/37/2/HERI/Studies/Reports/herirp02/herirp02-e.pdf>.

On September 25, 2003, the Minister of Industry, Allan Rock, tabled in the House of Commons the Canadian Government’s response to recommendations of the Industry Report. In its response, the Government acknowledged that (1) removing the Canadian ownership requirements would benefit the telecommunications industry, and (2) it would be irresponsible not to pursue the symmetrical removal of similar restrictions in respect of BDUs at the same time. However the Government noted that the Heritage Report had expressed contrary views on the removal of the Canadian ownership requirements. Accordingly, in order to reconcile these two conflicting policy recommendations, the Government undertook the immediate launch of an analysis on this issue, so that by the spring of 2004, it would be in a position to examine possible solutions. Press Release, Industry Canada, Government Responds to Industry Committee’s Recommendations on Foreign Investment Restrictions in Telecommunications (Sept. 25 2003), available at <http://www.ic.gc.ca/cmb/welcomeic.nsf/261ce500dfcd7259852564820068dc6d/85256a5d006b972085256dac00616a22!OpenDocument>.

B. The Evolution of Efficiency Analysis

The focus of competition policy on the promotion of efficiency has not always been clearly understood and remains controversial. Historically, U.S. competition authorities and U.S. courts were hostile to M&A that significantly increased market share concentration, regardless of whether they produced efficiencies. Today, there remains under U.S. antitrust laws a cautious hesitancy toward permitting efficiencies to trump concentration concerns in all but close cases. Moreover, telecom M&A activity involving U.S. operations adds an additional layer of complexity in that most telecom transactions are also subject to approval by the U.S. Federal Communications Commission ("FCC"), which applies a broad public interest standard that gives due consideration to efficiencies benefits when determining whether, on balance, the transaction is in the public interest.

Although the European Union appears to have recognized the advances made in economic and financial theory during the latter half of the twentieth century in drafting the European Community Merger Regulation ("ECMR"),⁴ to date, efficiencies have been more of a detriment than a benefit to merging entities. In contrast, not only has the Canadian Government adopted legislation that expressly authorizes the consideration of efficiencies, but the courts in Canada have also applied the legislation so as to permit full consideration of efficiencies. As the marketplace continues to evolve globally, convergence among the major enforcement authorities on fundamental competition principles, such as the role of efficiencies, will be critical.

It is not surprising that the treatment of efficiencies remains controversial, if not confused. There exist several difficult and determinative factors and policies surrounding the implementation of efficiencies, including: (1) what type of efficiencies should count, (2) what welfare standard should be applied, (3) what standard of proof should be imposed, and (4) how efficiencies should be factored into the analysis. As discussed later in this paper, there are neither easy nor consistent answers.

This paper is divided into four parts. In the first part, we explore some of the efficiencies-based motivations and rationales for telecom M&A. In the second part, we review the procedures and regulatory authorities responsible for telecom merger review in the United States, Europe, and Canada. In the third part, we examine the treatment of efficiencies in the

4. Council Regulation 4064/89 on the Control of Concentrations Between Undertakings, 1989 O.J. (L 395) 1, amended by Council Regulation 1310/97, 1997 O.J. (L 180) 1.

context of merger review in the three jurisdictions. Finally, we discuss some of the outstanding policy issues relating to the treatment of efficiencies.

II. EFFICIENCIES AND THE RATIONALE FOR TELECOM MERGERS

A. Introduction

Traditional “production-based” theories posit that the primary motivations for mergers are the acquisition of market power and the achievement of economies of scale. In combining resources and customers, firms hope to create market power by eliminating actual competition or potential competition. In addition, because many television firms are still subject to substantial economic regulatory oversight, some mergers are undertaken to enable a firm to avoid effective regulation or facilitate the company in leveraging its existing monopoly power in the regulated market into another unregulated market.⁵

Ignoring goals of market power, which of course do not sit well with competition authorities, M&A in the telecom sector can allow firms to increase geographic reach or expand small-scale operations into large-scale ones. Following the completion of a merger, some firms find that they can offer a less expensive, more efficient, and broader range of services to consumers through joint production, while others can leverage their existing networks for better capacity utilization. In particular, operating efficiencies may result from combined networks through reduced leased-line costs, the avoidance of expensive termination charges internationally and domestically, the combination of infrastructure assets, and the sale or redeployment of redundant assets.

B. Production-Based Theory and Economies of Scale and Scope

In general, whenever a merger expands a network, cost savings associated with production efficiencies may result through conventional economies of scale and, to a lesser degree, economies of scope and density. As firms seek to achieve optimal scale, inefficiently scaled firms will be driven from the market by exit or acquisition. Merging the operations of two firms may reduce duplication, allow fixed expenditures to be spread across a larger base of output, and permit firms to reorganize services across their combined networks.

5. See Jerry Ellig, *Telecommunications Mergers and Theories of the Firm*, in *ENTREPRENEURSHIP AND THE FIRM: AUSTRIAN PERSPECTIVES ON ECONOMIC ORGANIZATION* 193, 194 (Nicolai J. Foss & Peter G. Klein eds., 2002).

Production efficiencies include savings that flow from specialization, elimination of duplication, reduced downtime, smaller base of spare parts, smaller inventory requirements, and avoidance of capital expenditures that would otherwise have been required. Further savings can arise from the rationalization of research and development (“R&D”) activities and various administrative and management functions (e.g., sales, marketing, accounting, purchasing, finance, and production). In addition, M&A can bring about efficiencies in relation to distribution, advertising, and capital raising.⁶

Companies also can increase productive efficiency through economies of scope. Such savings result from the cost savings of providing two products or services together rather than separately. Potential sources of scope savings include common raw inputs, complementary technical knowledge, and reduction in or elimination of distribution channels and sales forces.

In the context of telecommunications networks, economies of scale can be significant due to the considerable investment in network infrastructure (e.g., fiber-optic cable, submarine cables, and cellular towers) and related operational software. In these cases, the associated technology platform can be used to produce additional output with minimal increases in variable costs (up to the point of maximum capacity). A sample collection of examples of economies of scale and scope that can be achieved in telecom M&A is provided below. It must be recognized that many of the cost savings described in these M&A have been analyzed through the eyes of the FCC, which reviews telecom transactions in the context of the “public interest.”⁷

6. See Fabienne Ilzkovitz & Roderick Meiklejohn, *European Merger Control: Do We Need an Efficiency Defence?*, 5 EUR. ECON. 4 (2001), available at http://europa.eu.int/comm/economy_finance/publications/european_economy/2001/eers0501_en.pdf.

7. However, economies of density may not be as significant because network traffic is normally collected and routed in a decentralized fashion such that routing telecommunications traffic through densely populated portions of the network may be less than optimal. Richard Schwindt & Steven Globerman, *Evaluating the Efficiency Consequences of Mergers in Network Industries: Complications and Concerns*, in PAPERS OF THE CANADIAN BAR ASSOCIATION ANNUAL FALL CONFERENCE ON COMPETITION LAW—1999 at 299 (Glenn F. Leslie ed., 1999).

1. More Intensive Use of Physical and Intellectual Property

In the AT&T/TCI transaction,⁸ the parties claimed that additional traffic could be routed over existing switches and transport facilities, allowing fixed costs to be spread across more lines and services.⁹

In the SBC/Ameritech merger,¹⁰ the parties submitted that product development and testing costs could be spread over a larger number of access lines, and \$54 million could be saved annually by reducing office space.¹¹ The parties also projected cost savings of \$313 million from combining their respective provisioning and maintenance, switching operations and network engineering, and other miscellaneous categories of savings.¹²

2. More Efficient Deployment of Radio Spectrum

In the Nextel/Motorola transaction,¹³ the FCC noted that by integrating Motorola's 900 MHz service into Nextel's 800 MHz spectrum, Nextel would "be in a position to make the highest valued use of the spectrum."¹⁴

8. On June 24, 1998, AT&T Corporation and Tele-Communications, Inc. announced they intended to merge, with AT&T becoming the parent company of TCI in an all-stock transaction valued at approximately \$48 billion. ("AT&T/TCI"). Press Release, AT&T, AT&T, TCI to Merge, Create New AT&T Consumer Services Unit (June 24, 1998), available at <http://www.att.com/news/0698/980624.cha.html>.

9. Ellig, *supra* note 5, at 209; see also Applications of Teleport Comm. Group Inc. and AT&T Corp., *Memorandum Opinion and Order*, 13 F.C.C.R. 15236, para. 34, 12 Comm. Reg. (P & F) 1095 (1998) [hereinafter *AT&T/TCI Order*].

10. On May 11, 1998, SBC and Ameritech announced their intention to merge in a \$62 billion deal, with the combined company being called SBC and the company being owned by approximately fifty-six percent of SBC's existing shareholders and forty-four of Ameritech's existing shareholders ("SBC/Ameritech"). See Seth Schiesel, *\$62 Billion Deal to Shift Balance in Phone Industry*, N.Y. TIMES, May 12, 1998, at A1; Press Release, SBC, SBC Communications and Ameritech to Merge (May 11, 1998), available at http://www.sbc.com/press_room/1,,31,00.html?query=2625.

11. Ellig, *supra* note 5, at 209; see also Applications of Ameritech Corp. and SBC Comm. Inc., *Memorandum Opinion and Order*, 14 F.C.C.R. 14712, para. 339, 18 Comm. Reg. (P & F) 1 (1999) [hereinafter *SBC/Ameritech Order*].

12. *SBC/Ameritech Order*, *supra* note 11, para. 325.

13. "On September 25, 2000, . . . Motorola and Nextel filed applications seeking [FCC] consent for Motorola to assign [fifty-nine] 900 MHz SMR licenses to Nextel." Applications of Motorola, Inc. and FCI 900, Inc. and FCI 900, Inc., *Memorandum Opinion and Order*, 16 F.C.C.R. 8451, para. 2 (2001) (footnotes omitted).

14. *Id.* para. 36.

In the Nextel/Pacific Wireless transaction,¹⁵ the FCC agreed that the more efficient use of spectrum, the additional services that would be provided to current customers, and Nextel's increased ability to compete in the commercial mobile radio services ("CMRS") marketplace, all constituted merger-specific public interest benefits.¹⁶

3. Systems Economies

A merged firm needs to retain only one "system" to manage its combined facilities and operations. In SBC/PacTel,¹⁷ the FCC agreed that the transactions would allow the merged entity to provide lower-cost, long-distance service through the combination of software development, customer service, billing, and collection.¹⁸ In SBC/Ameritech, the parties claimed cost savings from combining their administrative functions, Yellow Pages, wireless service, and Internet service business activities.¹⁹ In the Bell Atlantic/GTE transaction,²⁰ the FCC stated that the transaction "should also produce system-wide efficiencies through common network engineering, management, purchasing, and administrative functions, lending to earlier and broader deployment of advanced wireless services."²¹ As these examples illustrate, the elimination of redundant systems or consolidation of systems can result in significant savings.

15. "On July 27, 2001 . . . Pacific Wireless Technologies and Nextel filed an application seeking [FCC] consent for Pacific Wireless to assign [one hundred eighty-eight] 800 MHz SMR licenses to Nextel." Applications of Pac. Wireless Techs., Inc. and Nextel of Cal., Inc., *Memorandum Opinion and Order*, 16 F.C.C.R. 20341, para. 2 (2001) (footnotes omitted).

16. *Id.* para. 18.

17. On April 1, 1996, SBC and Pacific Telesis Group agreed to merge in a deal with a reported value of between \$16.7 billion and \$24 billion ("SBC/PacTel"). See Mark Landler, *Two Bell Companies Agree to Merger Worth \$17 Billion*, N.Y. TIMES, Apr. 2, 1996, at A1.

18. See Applications of Pac. Telesis Group, and SBC Comm. Inc., *Memorandum Opinion and Order*, 12 F.C.C.R. 2624, para. 74, 6 Comm. Reg. (P & F) 137 (1997) [hereinafter *SBC/PacTel Order*].

19. *SBC/Ameritech Order*, *supra* note 11, para. 325.

20. On July 28, 1998, Bell Atlantic announced that it intended to buy GTE for \$52.8 billion in stock. ("Bell Atlantic/GTE"). See Seth Schiesel & Laura M. Holson, *Two Phone Giants Reported Merging in \$52 Billion Deal*, N.Y. TIMES, July 28, 1998, at A1.

21. Application of GTE Corp. and Bell Atlantic Corp., *Memorandum Opinion and Order*, 15 F.C.C.R. 14032, para. 377, 20 Comm. Reg. (P & F) 989 (2000) [hereinafter *Bell Atlantic/GTE Order*].

4. Advertising and Customer Acquisition

In Bell Atlantic/GTE, the parties argued that greater scale and advertising or marketing synergies would allow the merged entity to achieve efficiencies needed to develop a national brand.²² Further, the acquisition of GTE's customers would provide Bell Atlantic with instant access to customers outside of its territory.²³

In AT&T/TCI, the parties expected to achieve lower costs of customer acquisition by cross-selling services (selling AT&T's long distance to TCI's cable subscribers) and by using existing sales forces.²⁴ The FCC stated:

By combining AT&T's strong brand name and substantial base of residential, long distance customers with [TCI's] substantial local facilities and expertise and knowledge in providing local services, the merged entity should be better situated than either AT&T or [TCI] individually to compete more quickly for residential customers in multiple dwelling units in high density markets in the short run, and for broader groups of residential customers in the longer run.²⁵

In SBC/PacTel, the FCC recognized that "by increasing SBC/PacTel's customer base, [the proposed transaction] may also make feasible the development of new products and services that need a large customer base in order to be economically viable."²⁶

In the MCI/WorldCom merger,²⁷ the parties claimed that "[b]y linking WorldCom's local facilities to MCI's long distance customer base, the combined company will substantially enhance its effectiveness in competing with the incumbent local exchange carriers."²⁸

22. See *Bell Atlantic/GTE Order*.

23. See *id.*, para. 225.

24. See Ellig, *supra* note 5, at 209-10.

25. *AT&T/TCI Order*, *supra* note 9, para. 34.

26. *SBC/PacTel Order*, *supra* note 18, para. 76.

27. On November 10, 1997, MCI Communications Corporation and WorldCom, Inc. announced that they intended to merge into a combined entity in a \$36.5 billion deal ("MCI/WorldCom"). Seth Schiesel, *MCI Accepts Offer of \$36.5 Billion; Deal Sets Record*, N.Y. TIMES, Nov. 11, 1997, at A1; see also Application of WorldCom, Inc. and MCI Comm. Corp., *Memorandum Opinion and Order*, 13 F.C.C.R. 18025, 13 Comm. Reg. (P & F) 477 (1998).

28. Applications of WorldCom, Inc. and Howard A. White, Trustee, *Applications and Request for Special Temporary Authority, Volume I*, Oct. 1, 1997, p. 33 (footnotes omitted) (on file with the Journal).

5. Savings in Purchasing

In the Bell Atlantic/NYNEX merger,²⁹ the parties “expect[ed] to achieve capital purchasing savings from [the] increased volume discounts the two companies [would] obtain [by pooling] their annual network capital expenditures.”³⁰

In Bell Atlantic/GTE, the FCC stated that “combining these wireless businesses will likely produce cost savings and operating efficiencies by reducing the [parties’] collective dependence on costly roaming agreements.”³¹

C. Resource-Based Theories

Motivations for telecom mergers can also be explained using resource-based theories of strategic management that “imply that mergers may occur when they facilitate the creation or recombination of distinctive intercompany that confer competitive advantages.”³² Resource-based theory defines a firm as a collection of resources and capabilities and assumes that different firms’ resources and capabilities can be heterogeneous and immobile. Accordingly, “some firms are better than other firms at doing some things,” and the combination of these complementary resources and capabilities can enhance value and corporate profitability.³³

Resources can either be tangible items (e.g., raw materials) or intangible items (e.g., intellectual property, firm-specific human capital, organizational culture, business relationships, or tacit knowledge). Capabilities are the experience, abilities, and knowledge that enable a firm to undertake its activities. While some capabilities are easy for firms to create on their own, mergers seek to acquire the capabilities that require considerable investment and time, and are difficult to duplicate in the short run.³⁴

29. On April 22, 1996, Bell Atlantic and NYNEX announced that they intended to merge in a stock-for-stock transaction totaling \$22.1 billion (“Bell Atlantic/NYNEX”). See Mark Landler, *Nynex and Bell Atlantic Reach Accord on Merger; Links 36 Million Customers*, N.Y. TIMES, Apr. 22, 1996, at A1.

30. Applications of NYNEX Corp. and Bell Atlantic Corp., *Memorandum Opinion and Order*, 12 F.C.C.R. 19985, para. 163, 9 Comm. Reg. (P & F) 187 (1997) [hereinafter *Bell Atlantic/NYNEX Order*].

31. *Bell Atlantic/GTE Order*, *supra* note 21, para. 377.

32. Ellig, *supra* note 5, at 193.

33. *See id.* at 196-97.

34. *See id.* at 197.

1. Expansion

Major telecom firms seek to expand their array of services, both in types of services offered and within geographic areas offered. The combination of two sets of resources and capabilities allows firms to implement expansion strategies quickly and efficiently. For example, by merging existing cable and telephone facilities, the merged entity can offer a combination of local phone, Internet, long-distance, and broadband services more rapidly than either of the merging parties could do on its own. Further examples are provided below.

In the US West/Qwest transaction,³⁵ the FCC believed that “combining US WEST’s expertise in providing xDSL to the local loop with Qwest’s high speed, high-capacity network [would] expedite deployment of advanced services and on a broader basis than US WEST could have offered alone.”³⁶

In the SBC/BellSouth transaction,³⁷ the FCC agreed with the parties “that the creation of another national wireless competitor constitute[d] a clear, transaction-specific public interest benefit. A significant percentage of mobile phone users desire nationwide access, and those users will benefit significantly from the creation of another competitor with a near-nationwide footprint.”³⁸

In the Deutsche Telekom/VoiceStream/PowerTel transaction,³⁹ the FCC agreed with the parties “that the build-out and extension of VoiceStream’s network to expand [its] reach significantly, both nationwide

35. On July 18, 1999, Qwest Communications International Inc. announced its intention to acquire US West, Inc. in a \$36 billion deal. See Laura M. Holson, *Complex Telephone Takeover Battle Ends in Compromise*, N.Y. TIMES, July 19, 1999, at B6.

36. Applications of Qwest Comm. Int’l Inc. and US West, Inc., *Memorandum Opinion and Order*, 15 F.C.C.R. 5376, para. 60, 19 Comm. Reg. (P & F) 1010 (2000).

37. On April 4, 2000, SBC and BellSouth Corp. announced their intention to merge their wireless operations. The companies would share joint and equal control of the entity, with SBC having a sixty percent ownership interest and BellSouth having a forty percent interest in the merged entity (“SBC/BellSouth”). See Seth Schiesel, *2 Phone Giants Said to Be Near Deal to Merge Wireless Units*, N.Y. TIMES, Apr. 5, 2000, at C1; Nicole Harris, *SBC, BellSouth Confirm Venture*, WALL ST. J., Apr. 6, 2000, at B10.

38. Applications of SBC Comm. Inc. and BellSouth Corp., *Memorandum Opinion and Order*, 15 F.C.C.R. 25459, para. 48 (2000).

39. On July 23, 2000, Deutsche Telekom AG announced its intention to purchase the VoiceStream Wireless Corporation for \$50.7 billion. See Andrew Ross Sorkin & Simon Romero, *Deutsche Telekom To Pay \$50 Billion For U.S. Company*, N.Y. TIMES, July 24, 2000, at A1. On August 26, 2000, Deutsche Telekom announced it intended to purchase PowerTel, Inc. (contingent on consummation of the VoiceStream merger) for \$7.1 billion in stock and debt. See Applications of Voicestream Wireless Corp., PowerTel, Inc., and Deutsche Telekom AG, *Memorandum Opinion and Order*, 16 F.C.C.R. 9779, para. 10.

and internationally, constitute[d] a clear, transaction-specific public interest benefit.”⁴⁰

In the SES Global/GE Americom transaction,⁴¹ the FCC stated: The combination of SES’s operations with the Americom Licensees’ operations will provide SES Global with the ability to provide satellite communications services throughout most of the world and could potentially enable the merged entity to realize economies of scale and scope in areas such as satellite control operations and research and development.⁴²

2. Intangible Benefits and Synergies

Instant benefits can arise from the acquisition of intangible assets, “such as brand names, customer relationships, hard-to-duplicate human capital, functional capabilities, [marketing, technological, and operational] and best practices.”⁴³ These benefits may also be characterized as “synergies” that relate to the marginal cost savings or quality improvements from any source other than the realization of economies of scale.⁴⁴ Examples include improved interoperability between complementary products (e.g., seamless interface between equipment) and sharing of complementary skills. “Synergies require cooperation and coordination of the two firms’ assets that allow production on a superior

40. Applications of VoiceStream Wireless Corp., PowerTel, Inc., and Deutsche Telekom AG, *Memorandum Opinion and Order*, 16 F.C.C.R. 9779, para. 121, 23 Comm. Reg. (P & F) 1089 (2001).

41. On March 28, 2001, SES, S.A., a Luxembourg-based satellite communication company, announced its intention to purchase GE Americom for \$5 billion, forming a combined entity called SES Global. See Andy Patztor, Nikhil Deogun and Matt Murray, *SES Nears Pact To Buy GE’s Satellite Unit*, WALL ST. J., Mar. 27, 2001, at A3; Press Release, SES Americom, Combination of SES and GE Americom Creates the World’s Premier Satellite Services Provider (Mar. 28, 2001), available at <http://www.gecapital.com/news/press/03282001.html>.

42. Application of General Electric Capital Corp. and SES Global S.A., *Order and Authorization*, 16 F.C.C.R. 17575, para. 52 (2001).

43. Ellig, *supra* note 5, at 210; see also *Bell Atlantic/GTE Order*, *supra* note 21, where the FCC noted:

Elimination of duplicative or redundant administrative functions and reduction of future equipment purchases, for instance, are direct consequences of the merger. The same is true with respect to some types of best practices, such as when superior methods of provisioning and maintenance operations are transferred between companies or when economies of scale are achieved as a result of the merger. Although these cost savings may be merger specific, they may nonetheless be the result of decreases in output or reductions in product differentiation.

Id., para. 241 (footnotes omitted).

44. See MAX M. HABECK, ET AL., AFTER THE MERGER: SEVEN STRATEGIES FOR SUCCESSFUL POST-MERGER INTEGRATION (2000) (suggesting that “growth” synergies should be the primary reason and focal point of acquisitions).

production function, as distinct from causing different *choices* (such as scale) on a fixed production function. In other words, synergies allow output/cost configurations that would not be feasible otherwise.”⁴⁵

In SBC/PacTel, the parties argued that the proposed transaction would bring together two companies with complementary strengths, specifically SBC’s marketing strength and PacTel’s technical and cost management expertise, and that their combination should enhance the development of new services and products for their local exchange customers.⁴⁶

In the Arch/PageNet transaction,⁴⁷ the FCC noted that the combination of PageNet’s narrowband operations with Arch’s relative financial and marketing strength was likely to result in faster and more robust development of narrowband PCS services.⁴⁸

In SBC/Ameritech, the FCC deemed only a portion of the cost savings as “merger-specific.” These savings included elimination of duplicative or redundant administrative functions; the reduction in future equipment purchases; some types of best practices, such as when superior methods of provisioning service and maintaining operations are transferred between companies; and economies of scale or scope that could not be achieved but for the merger.⁴⁹

In AT&T/TCI, the FCC stated that TCI will have “instant access to AT&T’s expertise and established telephony brand to support the combined entity’s new product offerings, both on a packaged and individualized basis, and to support its marketing efforts.”⁵⁰ The FCC further stated:

[T]he complementary nature of the merging firms’ assets means that the combined firm will be able to provide an alternative to the incumbent LECs’ services for residential customers far more quickly and effectively than either could separately. TCI possesses the “last mile” assets, while AT&T possesses a brand name, experience and financial resources that improve TCI’s ability to capitalize on its network assets. We are committed to ensuring that residential local

45. Joseph Farrell & Carl Shapiro, *Scale Economies and Synergies in Horizontal Merger Analysis*, 68 ANTITRUST L.J. 685, 693 (2001).

46. *SBC/PacTel Order*, *supra* note 18, para. 75.

47. On November 8, 1999, Arch Communications Group, Inc. announced its intention to buy Paging Networks, Inc. (“Arch/PageNet”). Bloomberg News, *Arch Communications to Take Over Paging Network*, N.Y. TIMES, Nov. 9, 1999, at C4.

48. Application of Arch Comm. Group, Inc. and Paging Network, Inc., *Memorandum Opinion and Order*, 16 F.C.C.R. 3675, para. 17, 20 Comm. Reg. (P & F) 1095 (2000).

49. *SBC/Ameritech Order*, *supra* note 11, para. 326.

50. Applications of Tele-Communications, Inc. and AT&T Corp., *Memorandum Opinion and Order*, 14 F.C.C.R. 3160, para. 147, 15 Comm. Reg. (P & F) 29 (1999) [hereinafter *AT&T/TCI License Transfer Order*].

exchange competition becomes a reality sooner rather [than] later. One way this may occur more quickly is through combinations of complementary assets by emerging entrants such as AT&T and TCI.⁵¹

3. Bundling of Services

Several companies strategize to provide bundled services on the assumption that consumers prefer to purchase multiple services from one company. Large customers can realize economies of scale by using a single service provider, while ensuring uniformity of service and functionality across the enterprise, and establishing single point of accountability for keeping the network up and running.⁵²

In AT&T/TCI, the FCC stated as follows:

Post-merger, AT&T-TCI may well have lower costs in billing and servicing customers that subscribe to several of its products. In such a case, by offering these products as a package at a price below that of the individual prices of the package's components when sold separately, the merged firm would both lower costs and pass at least some of those cost savings on to consumers.⁵³

In SBC/PacTel, the FCC was of the view that the bundling of local access and long-distance services—a form of one-stop shopping—may be a desirable feature for some customers. The FCC concluded that SBC/PacTel's potential ability to offer this service would not be inherently anticompetitive, and the customers who want one-stop shopping would be able to choose the combined local and long-distance services of SBC/PacTel or one of its competitors. The FCC noted that one-stop shopping was a benefit arising from increased competition and that the FCC should not stop any carrier from being the first to provide it. The FCC stated that its priority was to promote efficient competition, not to protect competitors.⁵⁴

4. Research and Development

Technological change also motivates M&A. The large incumbents may be unable to achieve technological advances as quickly as smaller and more innovative companies. Alternatively, a firm may not have access to R&D resources for a particular technology or service. Given the rapid pace of innovation, firms may not have the time to develop innovations in-house

51. *Id.* para. 48.

52. See Ellig, *supra* note 5, at 210.

53. *AT&T/TCI License Transfer Order*, *supra* note 50, para. 125.

54. *SBC/PacTel Order*, *supra* note 18, para. 48.

if they seek to remain competitive and may need to purchase such innovations to keep up.⁵⁵

In SBC/PacTel, the FCC recognized that the proposed transfer would permit the companies to pool their R&D resources and thus avoid some duplication, and that PacTel would benefit from SBC's larger R&D subsidiary without having to undertake a costly expansion on its own.⁵⁶

In Bell Atlantic/NYNEX, the parties expected to save substantially in annual capital expenses by consolidating field trials of new equipment and test laboratories.⁵⁷

In the SBC/SNET transaction,⁵⁸ the FCC also noted that SNET's access to improved research capabilities would be a major benefit of the merger, and that consumers were "likely to see the benefits of ADSL technology more quickly as a result of SNET's merger with SBC."⁵⁹

D. Network Externalities

Transactions in the telecom industry often produce significant cost savings due to their "network" infrastructures. A "network" is a "set of interconnected production, distribution or consumption activities in which the value of the relevant activity to any one participant depends, in part, upon the nature and intensity of the production, distribution or consumption of other participants."⁶⁰ Network externalities arise when the value of a product increases as more people use it. To take the simplest example, the more people who use the telephone network, the greater its value to all network users, as well as to the owner of the network. Consumers may benefit from the increased likelihood of systems compatibility and interchangeability as well as from the achievement of scale and scope economies that lower the incremental cost of providing the product or service.

Thus, a telecom merger that combines two networks will automatically increase the value placed on the networks, thereby creating

55. Phil Prentice & Mark Fox, *Technology Firms: The Impact of Mergers and Acquisitions*, 13 INT'L COMPANY & COM. L.REV. 321, 324 (2002).

56. *SBC/PacTel Order*, *supra* note 18, para. 76.

57. *Bell Atlantic/NYNEX Order*, *supra* note 30, para. 163.

58. On January 5, 1998, SBC announced its intention to acquire Southern New England Telecommunications Corporation ("SNET") in a \$4.4 billion transaction. Press Release, SBC, Southern New England Telecommunications to Merge with SBC Communications, (Jan. 5, 1998), available at http://www.sbc.com/press_room/1,,31,00.html?query=6492.

59. Applications of Southern New England Telecomm. Corp. to SBC Comm., Inc., *Memorandum Opinion and Order*, 13 F.C.C.R. 21292, para. 45, 14 Comm. Reg. (P & F) 24 (1998) (footnote omitted).

60. Schwindt & Globerman, *supra* note 7, at 303.

consumption externalities. Further, if a telecom merger permits, for example, the merging companies to integrate more efficiently their technology platforms in order to provide advanced services (e.g., video telephony), more subscribers will be drawn to the network to receive the advanced services, and the network and its intrinsic value to all network members will therefore increase. These externalities can be characterized “as increments to consumer surplus” that should assist in offsetting any anticompetitive effects of higher postmerger prices, or, alternatively, as the “cost savings that subscribers will enjoy by being able to substitute” the advanced services for their next best and more expensive alternative.⁶¹

E. Technological and Standardization Efficiencies

Standardization of technology resulting from the combination of networks can generate significant social gains, particularly when the standard adopted is superior to alternatives. The gains may be less apparent, or not as readily achievable, however, where there are issues of compatibility between the networks.⁶² However, in addition to the creation of societal gains, the adoption of a dominant standard may engender certain costs on society. For example, the amalgamation of two wireless networks (and the subsequent retirement of one of the two systems) could impose significant migration costs on users and equipment providers.

III. COMPETITION REVIEW AND TELECOM MERGERS

A. United States

Both the FCC and U.S. Department of Justice (“DOJ”) review telecom mergers in the United States. The FCC’s review of telecom mergers arises by virtue of its power to approve the transfer of certain telecom licenses under the Communications Act of 1934.⁶³ In determining whether to approve a requested license transfer, the FCC deploys a “public interest” standard, which is a broader consideration than the standard antitrust “substantially lessening of competition” test, and encompasses the broad goals of the Communications Act (which include universal service, the deployment of new advanced services, the preservation of quality services, and diversity in broadcast programs).⁶⁴

61. *Id.* at 304.

62. *Id.* at 308.

63. Communications Act of 1934, ch. 652, 48 Stat. 1064 (codified as amended in scattered sections of 47 U.S.C.).

64. Le Blanc & Shelanski, *supra* note 1, at 14.

One of the prominent public interest factors is whether the proposed merger would foster or hinder competition and thereby affect consumers. In this regard, the FCC will conduct its own market analysis based upon information collected through public comments and submissions by the transaction parties. The FCC normally conducts its analysis based upon (1) definition of markets, (2) examination of participants and likely entrants, and (3) a determination of how the merger would enhance concentration or allow the merged entity to exercise market power.

The FCC also appears to consider efficiencies in a manner consistent with the DOJ's approach,⁶⁵ but then recognizes in certain transactions a broader range of potential benefits as being in the "public interest." Moreover, given the more recent public pronouncements by various U.S. antitrust officials suggesting that at least during the investigative stages a broader range of benefits might be recognized, the distinctions between the FCC's broader public interest-based grounds for permitting a transaction and the DOJ's efficiencies grounds may be blurring.

B. European Union

EU competition policies are set out in Articles 3, 81, and 82 of the European Community Treaty, under which the overall objective is to "[ensure] that competition in the internal market is not distorted."⁶⁶ In 1989, the European Council adopted the ECMR in order to provide the Competition Directorate of the European Commission ("EC") express authority to review mergers and other concentrations. Under the ECMR:

[The EC is required to] determine whether the transaction is "compatible with the common market." If a merger creates or strengthens a dominant position such that effective competition would be significantly impeded in the common market or in a substantial part of it, the transaction is [determined to be] "incompatible with the common market" and may be prohibited. The ECMR merger review framework operates under standards less explicit than those established in the United States.⁶⁷

65. See U.S. Dep't of Justice and Fed. Trade Comm'n, Horizontal Merger Guidelines § 4 (rev. ed. 1997), available at http://www.usdoj.gov/atr/public/guidelines/horiz_book/hmg1.html [hereinafter Horizontal Merger Guidelines].

66. Consolidated Version of the Treaty Establishing the European Community, 2002 O.J. (C 325) 1, 40.

67. Kevin R. Sullivan, et al., Antitrust Scrutiny of Telecommunications Mergers, Joint Ventures and Strategic Alliances—A Shift From Regulation to Enforcement, Paper for the International Bar Association Section of Business Law's 10th Annual Seminar on Telecommunications Services and Competition Law in Europe (May 10-11, 1999), available at <http://www.kslaw.com/library/articles.asp?16>. "However, in October 1997 the [EC] published a notice providing guidance as to how it determines the relevant

C. Canada

Traditionally, anticompetitive behavior in the Canadian telecom industry has been regulated by the Canadian Radio-television and Telecommunications Commission ("CRTC") through the enforcement of policies under the Canadian Telecommunications Act,⁶⁸ such as just and reasonable rates, equal access, and nondiscrimination. However, the CRTC has no independent authority to review and approve telecom mergers; such mergers fall under the ambit and jurisdiction of the Canadian Competition Bureau ("Canadian Bureau"). The Canadian Bureau and the CRTC share a common goal of fostering the growth of competitive communications markets. The two government agencies have regarded their respective roles as "complementary," particularly in the transition from an environment of regulated telecom monopolies to one of unregulated multiple competitive networks.⁶⁹

The overall analytical framework adopted in Canada for M&A review is similar to that adopted by U.S. antitrust authorities. The Canadian Competition Act⁷⁰ is administered by the Commissioner of Competition ("Canadian Commissioner"), who is appointed by the federal cabinet and oversees the Canadian Bureau. The Canadian Bureau focuses on market power by adopting a hypothetical-monopolist approach⁷¹ to market

market in reviewing competition cases, including mergers and joint ventures." *Id.* (footnote omitted).

68. Telecommunications Act, ch. 38, 1993 S.C. 1475 (Can.).

69. In 1997, Robert Lancop, then Assistant Deputy Director of Investigation and Research, Civil Matters, at the Canadian Bureau, defined the Bureau's growing role in the changing telecom regulatory environment:

The Bureau's experience with the deregulation of other industries such as the transportation sector, suggests that communications deregulation is soon likely to be accompanied by a degree of industry restructuring through mergers and acquisitions and the formation of strategic alliances. Moreover, global strategic alliances are becoming increasingly common as firms seek partners and new approaches to doing business in a rapidly changing environment. The Director [now Commissioner] will be carefully examining mergers and other transactions in this sector to determine if they prevent or lessen competition substantially without giving rise to offsetting efficiency gains.

Robert G. Lancop, The Role of the Competition Bureau in the Communications Marketplace, Remarks at the Third Annual Wireless Communications Congress (Oct. 27, 1997), available at <http://cb-bc.gc.ca/epic/internet/incb-bc.nsf/vwGeneratedInterE/ct01441e.html>.

70. Competition Act, R.S.C., c. C-34 (1985) (Can.).

71. For merger analysis under the Canadian Competition Act, a relevant market is defined conceptually in terms of the smallest group of products and smallest geographic area in relation to which sellers, if acting as a single firm (a "hypothetical monopolist") that was the only seller of those products in that area, could profitably impose and sustain a significant and nontransitory price increase above levels that would likely exist in the

definition and a generally similar approach to the analysis of barriers to entry and other qualitative assessment criteria. After the Canadian Bureau assesses a proposed merger, the Canadian Commissioner decides whether to approve the merger or to challenge the merger before the Competition Tribunal (“Tribunal”), a quasi-judicial body comprised of judges and lay members (typically economists or individuals with business experience). The Tribunal acts independently and separately from the Commissioner and the Bureau and has exclusive jurisdiction to adjudicate mergers.

IV. TREATMENT OF EFFICIENCIES IN ANTITRUST MERGER REVIEW

A. *United States*

1. From Hostility to Skepticism to Cautious Acceptance

As stated above, U.S. competition authorities have been historically hostile to M&A that increased market share concentration significantly, regardless of whether they produced efficiencies. In the 1960s and mid-1970s, the enforcement agencies and courts viewed the creation of efficiencies as potentially anticompetitive. Today, while the hostility has for the most part disappeared, the road to acceptance has been, and continues to be, a difficult one.

The governing substantive statute for U.S. M&A review is Section 7 of the Clayton Act.⁷² This section prohibits transactions in which the effect may be “substantially to lessen competition” or to tend to create a monopoly.⁷³ However, the section is silent on the issue of efficiencies. Thus, in 1995, the role of efficiencies in M&A antitrust review was examined in the Global Competitive Hearings conducted by the U.S. Federal Trade Commission (“FTC”). The resulting report (“FTC Global Report”)⁷⁴ endorsed integrating further efficiencies into the competitive effects analysis. Following issuance of the FTC Global Report, the FTC and the DOJ formed a joint task force to examine the role of efficiencies which culminated in the adoption of the 1997 Efficiencies Amendment to

absence of the merger. COMPETITION BUREAU, INDUSTRY CANADA, MERGER ENFORCEMENT GUIDELINES pt. 3.1 (1991), *available at* http://strategis.ic.gc.ca/pics/ct/meg_full.pdf [hereinafter CANADIAN MERGER GUIDELINES].

72. 15 U.S.C. § 18 (2002).

73. *Id.*

74. FTC, Hearings on Global and Innovation-Based Competition, Dkt./Case No. P951201 (Oct. 12, 1995), *available at* <http://www.ftc.gov/opp/global/GC101295.htm> [hereinafter FTC Global Report].

the 1992 Guidelines (“U.S. 1997 Revisions”).⁷⁵ The U.S. 1997 Revisions tied efficiencies directly to the competitive effects analysis, recognizing that lower costs may reduce the likelihood of coordinated interaction or the incentive to raise prices unilaterally. The list of recognized efficiencies was expanded to include improved quality, enhanced service, or new products. Efficiencies arising from anticompetitive reductions in output, service, or other competitively significant categories, such as innovation, were specifically excluded from the U.S. 1997 Revisions.

Pursuant to the U.S. 1997 Revisions, efficiencies must be “cognizable,” i.e., they must be: (1) merger-specific,⁷⁶ (2) verified,⁷⁷ and (3) not the result of anticompetitive reductions in output. The merger-specific requirement is significant because “[i]nstead of requiring proof that claimed efficiencies could not be achieved through some *hypothetical* alternatives such as unilateral expansion or competitor collaborations, [the U.S. antitrust authorities] have committed to evaluate claimed efficiencies against other *practical* alternatives.”⁷⁸

The U.S. 1997 Revisions incorporate a sliding scale approach under which the agencies will require proof of greater efficiencies as the likely anticompetitive effects of the transaction increase. The stronger the case for potential anticompetitive effects of a transaction, the greater the burden on the merger parties to demonstrate cognizable efficiencies. In a transaction suggesting strong anticompetitive potential, the parties shoulder a very high burden of proof that credible efficiencies will overcome the potential anticompetitive effects. Thus, the U.S. 1997 Revisions embrace the

75. DOJ & FTC, Horizontal Merger Guidelines (rev. ed. Apr. 8, 1997), *available at* http://www.usdoj.gov/atr/public/guidelines/horiz_book/hmg1.html [hereinafter U.S. Merger Guidelines and U.S. 1997 Revisions].

76. As FTC Chairman Muris wrote, “[T]he focus should not be on whether another method might exist to lower costs, but instead on whether the method is more or less costly than the merger and whether it can be implemented as rapidly as the merger.” Timothy J. Muris, *The Government and Merger Efficiencies: Still Hostile After All These Years*, 7 GEO. MASON L. REV. 729, 732 (1999) [hereinafter Muris 1999 Article].

77. According to the U.S. 1997 Revisions:

the merging firms must substantiate efficiency claims so that the [a]gency 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), how each would enhance the merged firm’s ability and incentive to compete, and why each would be merger specific.

U.S. Merger Guidelines and U.S. 1997 Revisions, *supra* note 75, ch. 4.

78. Robert Pitofsky, Efficiencies in Defense of Mergers: 18 Months After, Remarks to George Mason Law Review Antitrust Symposium: The Changing Face of Efficiency (Oct. 16, 1998), *available at* <http://www.ftc.gov/speeches/pitofsky/pitofeff.htm> [hereinafter Pitofsky remarks].

principle that efficiencies almost never justify a merger to monopoly or near monopoly.

Today, it is clear that the U.S. antitrust authorities, as a matter of their prosecutorial discretion, will consider efficiencies in close cases.⁷⁹ In the courts, however, the authorities appear to be still arguing that efficiencies cannot, and do not, trump high concentration levels. Since 1990, only four U.S. courts of appeals have considered the role of efficiencies in an M&A context.⁸⁰ In addition, in about a half-dozen M&A challenges, the district court considered whether efficiencies rebutted the government's prima facie showing of anticompetitive effects based solely on market share and concentration.⁸¹ In almost all court proceedings, the government has won on its prima facie case because the very high concentration levels asserted resulted in an insurmountable level of reluctance, if not hostility, against acceptance of the efficiencies proffered by the merging parties.

79. Ilene Knable Gotts & Calvin S. Goldman, *The Role of Efficiencies in M&A Global Antitrust Review: Still in Flux?*, 29 INT'L ANTITRUST L. & POL'Y, FORDHAM CORP. L. INST PROC. 201, 212 (Barry E. Hawk ed., 2003); see also, e.g., Statement of the FTC Amerisource Health Corp./Bergen Brunswig Corp., File No. 011-0122 (Aug. 24, 2001), available at <http://www.ftc.gov/os/2001/08/amerisourstatement.pdf> (stating that the 4-2-3 merger was permitted to proceed, at least in part, due to efficiencies); Timothy J. Muris, Understanding Mergers: Strategy and Planning, Implementation, and Outcomes, Remarks to the FTC's Roundtable on Understanding Mergers: Strategy and Planning, Implementation, and Outcomes (Dec. 9, 2002), available at <http://www.ftc.gov/speeches/muris/mergers021209.htm> [hereinafter Muris FTC Roundtable Remarks].

80. *FTC v. Tenet Health Care Corp.*, 186 F.3d 1045 (8th Cir. 1999) (finding that efficiencies are not merger specific and are too speculative); *FTC v. Butterworth Health Corp.*, No. 96-2440, 1997 U.S. App. LEXIS 40805 (6th Cir. July 8, 1997); *FTC v. Univ. Health, Inc.*, 938 F.2d 1206 (11th Cir. 1991); *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).

81. See generally *United States v. Country Lakes Foods, Inc.*, 754 F. Supp. 669, 674 (D. Minn. 1990). *Country Lakes Foods* was the only litigated nonhospital case in which efficiencies due to scale economies of product were expressly recognized. In *United States v. United Tote, Inc.*, 768 F. Supp. 1064 (D. Del. 1991), it was assumed that the merger would result in valid efficiency gains for the combined entity. The court found the efficiency gains would be insufficient to offset anticompetitive aspects and that there was no guarantee that the savings would be passed through to consumers. In *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997), the parties claimed that a combined entity would save between \$4.9 and \$6.5 billion over five years, including savings as a result of being able to extract better prices from vendors. The court rejected efficiencies as largely unverified from internal documents and failed to establish merger specificity since both parties were expanding rapidly on their own and Staples had passed through only 15-17% of past cost-savings. In *FTC v. Cardinal Health, Inc.*, 1998-2 Trade Cas. (CCH), para. 72,226 (D.D.C. 1998), the anticipated cost savings from increased economies of scale, including distribution center consolidation, elimination of corporate overhead, better purchasing practices, and increased volume buying power, were deemed to be achievable without the merger taking place. Because of the high market concentration, the court found that the efficiencies were not enough to outweigh the costs of foregoing competition. See also *H.J. Heinz Co.*, 116 F. Supp. 2d 190; *FTC v. Swedish Match*, 131 F. Supp. 2d 151 (D.D.C. 2000).

The recent *Heinz* case⁸² illustrates this judicial deference to concentration levels and concomitant hostility toward efficiencies in the United States. In an FTC preliminary injunction challenge to the transaction, the U.S. District Court for the District of Columbia found that the merger parties had rebutted the presumption created by the high and increasing market concentration by proving “extraordinary” efficiencies.⁸³ Subsequently, the FTC sought and obtained from the D.C. Circuit Court a stay of the district court’s decision and an injunction of the merger, pending appeal. After a hearing, the D.C. Circuit Court found the efficiencies evidence insufficient, both as a defense and as a basis for showing postmerger coordination unlikely, thereby effectively killing the transaction. Although the D.C. Circuit Court exhibited extreme skepticism and hostility to efficiencies due to the concentration levels that would exist postmerger, it did leave open the possibility that, at least in some cases, an efficiencies defense could succeed. The court held that the high market concentration levels present in *Heinz* required, in rebuttal, proof of “extraordinary” efficiencies.⁸⁴

2. Signs of Acceptance

The preference of the enforcement agencies historically has been to condemn transactions resulting in high concentration levels even in the face of likely significant efficiencies, rather than chance the possibility of permitting a transaction with potential adverse competitive effects to proceed. Although we agree there are transactions that should be viewed as “unthinkable,” even though they may create some efficiencies, it is in the closer calls that care must be taken not to prematurely judge a transaction as “good” or “bad” due to the disparity between the burdens imposed on the government and on the transaction parties. In those transactions killed by such insurmountable presumptions, there will never be an opportunity for society to potentially benefit from the associated efficiency gains. FTC Chairman Muris recently recognized the “chicken and egg” problem: due to adverse court decisions in the efficiencies area, some antitrust attorneys advise their clients not to make the effort necessary to develop their best efficiencies arguments, which results in the lack of favorable efficiencies precedent.⁸⁵ He indicates, however, that “internally we take substantial well-documented efficiencies arguments seriously. And we recognize that mergers can lead to a variety of efficiencies beyond reductions in variable

82. *H.J. Heinz Co.*, 116 F. Supp. 2d 190.

83. *Id.* at 198-200.

84. 246 F.3d at 720.

85. Muris FTC Roundtable Remarks, *supra* note 79.

costs.”⁸⁶ Moreover, Chairman Muris indicated that efficiencies can be important in cases that result in consent decrees and in the formulation of remedies that preserve competition while allowing the parties to achieve most, if not all, efficiencies. He reassured antitrust counsel that well-presented credible efficiencies will be given due consideration by the FTC in merger review.

3. The Role of Efficiencies in FCC Reviews

As stated above, the FCC reviews efficiencies in the context of the public interest. In Bell Atlantic/NYNEX, the FCC described the role of efficiencies in its public interest analysis:

Efficiencies are the pro-competitive benefits of a merger that improve market performance. Efficiencies generated through a merger can mitigate competitive harms if such efficiencies enhance the merged firm’s ability and incentive to compete and therefore result in lower prices, improved quality, enhanced service or new products. Pro-competitive efficiencies include only those efficiencies that are merger specific, *i.e.*, that would not be achievable but for the proposed merger. Efficiencies that can be achieved through means less harmful to competition than the proposed merger, therefore, cannot be considered to be true pro-competitive benefits of the merger. Efficiencies are particularly significant if they improve market performance in a relevant market and thereby reduce the competitive harms otherwise presented by the proposed merger. In order to mitigate competitive harms, however, efficiencies cannot result from anti-competitive reductions in output or service. Applicants bear the burden of showing both that merger specific efficiencies will occur, and that they sufficiently offset any harm to competition such that we can conclude that the transaction is pro-competitive and therefore in the public interest. Finally, applicants cannot carry their burden if their efficiency claims are vague or speculative, and cannot be verified by reasonable means.⁸⁷

The FCC was careful to caution: “Efficiencies are most likely to make a difference in our public interest review of a merger when the likely adverse competitive effects, absent the efficiencies, are not great. However, efficiencies almost never justify a merger to monopoly or near-monopoly.”⁸⁸

The FCC uses a strict test of merger specificity in deciding whether to accept claimed efficiencies. For example, in SBC/Ameritech, the FCC found that only a portion of the benefits claimed by the parties were merger

86. *Id.*

87. Applications of NYNEX Corp., and Bell Atl. Corp., *Memorandum Opinion and Order*, 12 F.C.C.R. 19985, para. 158, 9 Comm. Reg. (P & F) 187 (1997).

88. *Id.* para. 159.

specific and that each company could expand geographically or offer the products on its own. The FCC stated:

Specifically, each company individually could expand its respective wireless footprints through other acquisitions or joint ventures that do not threaten equivalent public interest harms. Each company could offer out-of-region Internet services today, so expanding its customer base of dial-up customers [that] could be achieved absent this merger. Each company could offer long distance services out-of-region and abroad today absent the merger. In-region, each company's ability to offer long distance services is subject to Section 271 authorizations which are not dependent on this merger. Each company could secure large business customers today in the global seamless services market by leveraging its substantial international holdings and by introducing a full suite of local and long distance voice and data products. These activities, therefore, are not dependent on the merger and could be accomplished individually.⁸⁹

The FCC also requires that claimed benefits be "verifiable." Because much of the information relating to the potential benefits of a merger is in the sole possession of the merging parties, those parties must provide sufficient support for any benefit claims so that the FCC can verify the likelihood and magnitude of each claimed benefit. In this regard, the magnitude of recognized benefits must take into account the cost of achieving them. Moreover, speculative benefits that cannot be verified will be discounted or dismissed. Thus, for example, benefits that are to occur only in the distant future may be discounted or dismissed because, among other things, predictions about the more distant future are inherently more speculative than predictions about events that are expected to occur closer to the present.⁹⁰

Further, benefits are generally counted only to the extent that they can mitigate any anticompetitive effects of the merger. Since, in general, reductions in marginal cost are more likely to result in lower equilibrium prices, the FCC has stated that it is "more likely [to] find marginal cost reductions to be cognizable than reductions in fixed cost."⁹¹

Like the U.S. antitrust authorities, the FCC applies a sliding scale approach to evaluating potential benefits, under which it will require applicants to demonstrate that claimed benefits are more likely and more

89. *SBC/AmeriTech Order*, *supra* note 11, para. 347.

90. Application of EchoStar Comm. Corp. and EchoStar Comm. Corp., *Hearing Designation Order*, 17 F.C.C.R. 20559, para. 190 (2002) [hereinafter *EchoStar*].

91. *Id.* para. 191.

substantial the greater the likelihood and magnitude of potential harms. More specifically:

As the harms to the public interest become greater and more certain, the degree and certainty of the public interest benefits must also increase commensurately in order for us to find that the transaction on balance serves the public interest. This sliding scale approach requires that where, as here, potential harms are indeed both substantial and likely, the Applicants' demonstration of claimed benefits also must reveal a higher degree of magnitude and likelihood than we would otherwise demand.⁹²

In its review of the proposed DirecTV/EchoStar merger, the FCC noted that the case law under antitrust laws has been generally hostile to proposed mergers that would have unfavorable impacts on the competitive structure, because such mergers are likely to increase the incentive and ability to engage in anticompetitive conduct. Competitive impacts are an important aspect of the FCC's public interest standard and the Telecommunications Act of 1996.⁹³ The FCC stated:

Competition in the communications industries is the cornerstone of our modern communications policy because it is well recognized that competition, rather than regulation of monopoly providers, has the greatest potential to bring consumer welfare gains of lower prices and more innovative services. Accordingly, a proposed transaction's consistency with the Act, our rules and competition policy in general is an integral part of our public interest review.⁹⁴

B. European Union

1. EU Precedent Generally Not Favorable to Efficiencies

To date, the European Union has not viewed efficiencies favorably in its merger review. In 1989, the Counsel of the European Communities issued the ECMR, which sets forth a comprehensive procedure pursuant to which the EC reviews the potential competitive impact of a transaction to determine whether to block the transaction.⁹⁵ The ECMR has a two-prong test: (1) creation or reinforcement of a market dominance position, and (2) resulting market power capable of significantly impeding effective

92. *SBC/AmeriTech Order*, *supra* note 11, para. 256 (footnote omitted)

93. The Telecommunications Act of 1996 aimed to establish a pro-competitive, deregulatory national policy framework that would open all telecommunications markets to competition, so as to accelerate private sector deployment of advanced telecommunications and information technologies. *See* Pub. L. No. 104-104, 110 Stat. 56 (codified at scattered sections of 47 U.S.C.).

94. *EchoStar*, *supra* note 90, para. 276.

95. Council Regulation (EEC) No. 4064/89 of 21 December 1989 on the Control of Concentrations between Undertakings, 1989 O.J. (L 395) 1 [hereinafter ECMR].

competition in a relevant market. In a series of European Court of Justice decisions, the court has indicated that market shares of fifty percent may result in a legal presumption of dominance.⁹⁶

Article 2(1) of the ECMR contains a detailed list of the factors that the EC must consider in its analysis, which include “the development of technical and economic progress provided that it is to consumers’ advantage and does not form an obstacle to competition.”⁹⁷ Thus, the ECMR, on its face, appears to require the EC to take into account efficiencies as a factor in determining whether the transaction creates or strengthens a dominant position, so long as (1) consumers benefit, and (2) the efficiencies do not become an obstacle to competition. The requirement that the technical and economic progress should not form an obstacle to competition makes it unlikely that a dominant firm will be able to assert efficiencies as a defense since any improvement in efficiency may enhance its market power. In such cases, efficiencies may even be treated as an offense. This view is illustrated by the EC’s actions in *Du Pont/ICI*⁹⁸ and *Shell*,⁹⁹ two transactions in which the EC required undertakings that sought to provide comparable or shared efficiency benefits for competitors before allowing the transactions to proceed.¹⁰⁰

The debate over the role of efficiencies has existed from the very outset of the ECMR regime. In *AT&T/NCR*,¹⁰¹ the EC rejected the transaction parties’ contentions that the merger would achieve important synergies in the development of more advanced communications technologies and noted that the potential advantages flowing from such

96. See, e.g., Case C-62/86, *AKZO Chemie BV v. Comm’n*, 1991 E.C.R. I-3359, I-3453, [1993] 5 C.M.L.R. 215, 279.

97. ECMR, *supra* note 95, at 3.

98. Comm’n Decision of 30 September 1992 Declaring the Compatibility of a Concentration with the Common Market (Case No. IV/M214—*Du Pont/ICI*), 1993 O.J. (L 7) 13 [hereinafter *Du Pont*].

99. Comm’n Decision of 8 June 1994 Declaring the Compatibility of a Concentration with the Common Market (Case No. IV/M. 269—*Shell/Montecatini*), 1994 O.J. (L 332) 48 [hereinafter *Shell*].

100. The EC permitted the *Du Pont/ICI* merger to occur only after *Du Pont* agreed to transfer to a third party a freestanding research and development facility of comparable quality to those operated by *Du Pont* and *ICI*. *Du Pont*, *supra* note 98, at 23. In *Shell*, the transaction parties were required to proffer undertakings that would preserve a second independent source of polypropylene technology licensing before the EC permitted the concentration to proceed. These undertakings were later withdrawn by the EC as no longer necessary in light of the FTC consent and subsequent sale of all of *Shell*’s polypropylene technology assets. See Comm’n Decision of 24 April 1996 Amending Decision 94/811/EC Declaring the Compatibility of a Concentration with the Common Market (Case No. IV/M. 269—*Shell/Montecatini*), 1996 O.J. (L 294) 10.

101. Non-Opposition to a Notified Concentration (Case No. IV/M 050—*AT&T/NCR*), 1991 O.J. (C 16) 20.

synergies may create or strengthen a dominant position. Subsequent EC decisions continued to exhibit hostility toward efficiencies. For instance, a few years later in *Accor/Wagons-Lits*,¹⁰² the EC considered whether the transaction would create a dominant position in the French motorway catering market. The EC rejected Accor's claims of scale economies, indicating that the combined firm "[would] have no interest to pass any assumed gains on to the consumer" because there might be potential diseconomies of scale; the cost reductions were not merger specific, and the concentration would form a significant obstacle to efficient competition.¹⁰³

In some cases, however, efficiencies have been an important basis for the EC's decision to clear a transaction.¹⁰⁴ Even in a joint venture context, the EC has at times treated efficiencies as an offense rather than a defense. For example, in *Bertelsmann/Kirch/Premiere*,¹⁰⁵ the EC rejected a proposed concentrative joint venture between Kirch and Bertelsmann to provide technical and administrative support for German digital pay-TV services. The EC summarily questioned the joint venture's likelihood of achieving the economies claimed, once it determined that the joint venture would create a dominant position in pay-TV markets.¹⁰⁶ Similarly, the EC blocked the formation of Nordic Satellite Distribution,¹⁰⁷ a proposed concentrative joint venture for satellite TV transponder services between

102. Comm'n Decision of 28 April 1992 Declaring the Compatibility with the Common Market of a Concentration (Case No. IV/M. 126—*Accor/Wagons-Lits*), 1992 O.J. (L 204) 1.

103. *Id.* at 10.

104. See Comm'n Decision of 11 Feb. 1998 Declaring a Concentration to be Compatible with the Common Market and the Functioning of the EEA Agreement (Case No IV/M.986—*Agfa-Gevaert/DuPont*) 1998 O.J. (L 211) 22; (Case No. IV/M.906—*Mannesmann/Vallourec*) Notification of 25/04/1997 Pursuant to Article 4 of Council [Regulation] 4064/89, available at http://europa.eu.int/comm/competition/mergers/cases/decisions/m906_en.pdf; Comm'n Decision of 14 February 1995 Relating to a Proceeding Pursuant to Council Regulation (EEC) No 4064/89 (Case No. IV/M.477—*Mercedes Benz/Kässbohrer*), 1995 O.J. (C 211) 1; Non-Opposition to a Notified Concentration (Case No. IV/M.354—*Cyanamid/Shell*), 1993 O.J. (C 273) 6; Comm'n Decision of 12 April 1991 Declaring the Compatibility with the Common Market of a Concentration (Case No IV/MO42—*Alcatel/Telettra*), 1991 O.J. (L 122) 48; see also Peter D. Camesasca, *The Explicit Efficiency Defence in Merger Control: Does It Make the Difference?*, 20(1) EUR. COMPETITION L. REV. 14 (1999) (indicating that the EC relied upon efficiencies to clear these mergers).

105. Comm'n Decision of 27 May 1998 Relating to a Proceeding Pursuant to Council Regulation (EEC) No 4064/89 (Case No IV/M.993—*Bertelsmann/Kirch/Premiere*), 1999 O.J. (L 53) 1.

106. *Id.* at 23-24.

107. Comm'n Decision of 19 July 1995 Declaring a Concentration to be Incompatible with the Common Market and the Functioning of the EEA Agreement (Case No. IV/M.490—*Nordic Satellite Distribution*), 1996 O.J. (L53) 20.

two Scandinavian telecom operations and a major Swedish content provider for TV programs. The EC expressed concerns regarding both market shares for transponder services and possible spillover effects in the upstream market where the parent companies enjoyed market power.¹⁰⁸ The EC did not view vertical integration of the operation of the transponders and content as necessary for a satellite operation to promote the satellite's operations.¹⁰⁹

The EC's decision in the proposed GE/Honeywell¹¹⁰ merger provides a stark example of the potential divergence between the United States and the European Union in the treatment of efficiencies in merger review.¹¹¹ After the EC prohibited the merger, EC Commissioner Mario Monti stated that the parties did not in his view "provide a clearly articulated and quantified defense in terms of efficiencies."¹¹² Notwithstanding the contrary opinion of the DOJ, the EC has maintained that price cuts resulting from mixed bundling of products are not the type of real efficiency that should be taken into account in a merger analysis, but instead constitute a form of "strategic pricing" by the merged firm.¹¹³

GE and Honeywell have appealed the decision to the European Court of Justice in Luxembourg.

2. Signs of Possible Change in Perspective in the Near Future

Critics have argued that a merger policy that does not take into account efficiency gains (including cost savings that are passed on to consumers in the form of lower prices) may be harmful to European competitiveness, especially in high-tech industries.¹¹⁴ Indeed, following the debates in the European Parliament on the EC's competition policy report

108. *Id.* at 31, 33.

109. *Id.* at 38.

110. Comm'n Decision of 03/07/2001 Declaring a Concentration to be Incompatible with the Common Mkt. and the EEA Agreement (Case No COMP/M.2220—General Electric/Honeywell), available at http://europa.eu.int/comm/competition/mergers/cases/decisions/m2220_en.pdf; see also Donna E. Patterson & Carl Shapiro, *Transatlantic Divergence in GE/Honeywell: Causes and Lessons*, 16 ANTITRUST 18 (2001).

111. The transaction was cleared in both the U.S. and Canada. See Press Release, DOJ, Justice Department Requires Divestitures in Merger Between General Electric and Honeywell, May 2, 2001, available at http://www.usdoj.gov/atr/public/press_releases/2001/8140.htm; Bloomberg News, *EU Blocks General Electric's Purchase of Honeywell*, (July 3, 2001), available at <http://www.ibj.com/daily/IBJDstories/04D070301.html>.

112. Mario Monti, Antitrust in the U.S. and Europe: A History of Convergence, Remarks to the General Counsel Roundtable of the ABA (Nov. 14, 2001), available at <http://www.eurunion.org/News/speeches/2001/011114mm.htm>.

113. Götz Drauz, *Unbundling GE/Honeywell: The Assessment of Conglomerate Merger Under EC Competition Law*, 25 FORDHAM INT'L L.J. 885, 907 (2002).

114. Ilzkovitz & Meiklejohn, *supra* note 6, at 11.

for 1999, the European Parliament issued resolutions that called for “efficiency and other pro-competitive elements” to be taken into account.¹¹⁵ Accordingly, the EC recently indicated that it is examining its views on efficiencies and may view efficiencies more favorably in the future.¹¹⁶ In July 2002, Commissioner Monti stated, “[W]e are not against mergers that create more efficient firms. Such mergers tend to benefit consumers, even if competitors might suffer from increased competition.”¹¹⁷ Commissioner Monti has offered further guidance concerning the likely direction of certain pending changes. Most notable from a substantive standpoint, he (1) expressed support for an efficiencies defense,¹¹⁸ (2) noted that reform will be accompanied by the issuance of interpretive market power guidelines to assist in providing market definition and in determining how efficiency considerations should be taken into account, and (3) indicated that the European Union will not stop mergers simply because they reduce cost and allow the combined firm to offer lower prices, thereby reducing or eliminating competition. Commissioner Monti concluded, however, that “it is appropriate to maintain a touch of ‘healthy scepticism’ with regard to efficiency claims, particularly in relation to transactions which appear to present competition problems.”¹¹⁹

On November 7, 2002, Commissioner Monti gave a major address in which, among other things, he explained further the evolving role of

115. Minutes of 24 Oct. 2000, 2001 O.J. (C 197) 20.

116. A debate on the role of efficiencies under the ECMR was launched on December 11, 2001, with the publication of a green paper addressing EU merger policy and practices. EUR. COMM’N, GREEN PAPER ON THE REVIEW OF COUNCIL REGULATION No. 4064/89 (2001), available at www.europa.eu.int/comm/competition/mergers/review/green_paper/en.pdf. Indeed, a broader philosophical discussion is also underway regarding whether to replace the dominance test with the substantial lessening of competition test in existence elsewhere, including in the U.S. and Canada. See, e.g., EUR. COMM’N, GREEN PAPER ON THE REVIEW OF COUNCIL REGULATION (EEC) No. 4064/89: SUMMARY OF REPLIES RECEIVED, at 15-20.

117. Mario Monti, The Future for Competition Policy in the European Union, Speech at Merchant Taylor’s Hall, London (July 9, 2001), available at http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=SPEECH/01/340/0.

118. Commissioner Monti is the first economist to be EU Competition Commissioner. In his June 4, 2002 speech, he indicated that “the Commission does not rely on the fact that efficiencies resulting from a merger are likely to have the effect of reducing or eliminating competition in the relevant market (for example, by enabling lower prices to be charged to customers), as a ground for opposing a proposed transaction. . . .” Mario Monti, European Competition Commissioner, Review of the EC Merger Regulation-Roadmap for the Reform Project Conference on Reform of European Merger Control, British Chamber of Commerce, at 5 (June 4, 2002), available at http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.getfile=gf&doc=SPEECH/02/252/0/AGED&lg=EN&type=PDF [hereinafter Monti British Chamber Speech].

119. Monti British Chamber Speech, *supra* note 118, at 7.

efficiencies.¹²⁰ He expressed that an explicit recognition of merger-specific efficiencies is possible within the mandate of the ECMR¹²¹ and further indicated that:

[T]he Commission intends to carefully consider any efficiency claim in the overall assessment of the merger, and may ultimately decide that, as a consequence of the efficiencies the merger brings about, the merger does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded.¹²²

The draft European Union Merger Guidelines¹²³ issued in December 2002 similarly indicate that:

The Commission welcomes corporate [reorganizations] . . . [and] takes into account . . . the development of technical and economic progress provided that it is to the consumers' advantage and does not form an obstacle to competition.

The Commission considers any substantiated efficiency claim in the overall assessment of the merger. It may decide that, as a consequence of the efficiencies that the merger brings about, this merger does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded. This will be the case when the Commission is in a position to conclude on the basis of sufficient evidence that the efficiencies generated by the merger are likely to enhance the incentive of the merged entity to act pro-competitively for the benefit of consumers, by counteracting the effects on competition which the merger might otherwise have.¹²⁴

The EU Draft Guidelines further require that "the efficiencies have to be of direct benefit to consumers and . . . be merger-specific, substantial, timely, and verifiable."¹²⁵ It will be interesting to see how the EU will apply this framework in practice.

120. Mario Monti, Merger Control in the European Union: A Radical Reform, Speech at the European Commission/IBA Conference on EU Merger Control, (Nov. 7, 2002), available at http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.getfile=gf&doc=SPEECH/02/545|0|AGED&lg=EN&type=PDF [hereinafter Monti Speech at European Commission]. This formulation of the efficiencies defense by Monti is similar to that contained in the U.S. 1997 Revisions. U.S. Merger Guidelines and U.S. 1997 Revisions, *supra* note 75.

121. Monti Speech at European Commission, *supra* note 120, at 5.

122. *Id.*

123. Draft Comm'n Notice on the Appraisal of Horizontal Mergers under the Council Regulation on the Control of Concentrations Between Undertakings, 2002 O.J. (C 331) 18 [hereinafter EU Draft Guidelines].

124. *Id.* at 28 (footnote omitted).

125. *Id.*

C. Canada

Both the United States and the European Union may find the treatment of efficiencies in Canada, which has statutorily embraced an efficiency defense, pertinent to their consideration of efficiencies. This defense has been subject to extensive litigation and interpretation, twice before the Canadian Competition Tribunal and twice before the Canadian Federal Court of Appeal, in the case of *Superior Propane*, discussed in detail below.¹²⁶

1. The Statutory Efficiency Defense

The Canadian Parliament enacted the statutory efficiency defense¹²⁷ in 1986 as part of a series of amendments to the Combines Investigation Act, Canada's then antitrust statute and the predecessor to the current Competition Act.¹²⁸ Theoretically, the defense permits a merger that prevents or lessens, or is likely to prevent or lessen, competition substantially in any market in Canada so long as the efficiency gains resulting from the merger exceed the anticompetitive effects of the merger. In practice, merging parties may raise the defense, both in the initial assessment phase before the Canadian Bureau and again, if necessary, when the Canadian Commissioner has brought an application before the Tribunal challenging the merger.

The defense requires that efficiency gains be greater than or offset the anticompetitive effects of any prevention or lessening of competition resulting from the merger. The Canadian Merger Enforcement Guidelines ("Canadian Merger Guidelines") prescribe two classes of efficiency gains that will be assessed under the efficiency defense: (1) production efficiencies and (2) dynamic efficiencies. Production efficiencies "are generally the focus of the evaluation, because they can be quantifiably measured, objectively ascertained, and supported by engineering, accounting, or other data."¹²⁹ Further, "dynamic efficiencies[] include gains attained through the optimal introduction of new products, the development of more efficient productive processes and the improvement of product quality and service."¹³⁰

126. Blake, Cassels & Graydon, LLP, with a legal team led by Neil Finkelstein, was counsel to Superior Propane, Inc. and ICG Propane Inc. in all of the hearings and proceedings before the Tribunal and the Federal Court of Appeal.

127. CANADIAN MERGER GUIDELINES, *supra* note 71, app. II.

128. Calvin Goldman headed the Canadian Bureau when the efficiency defense amendment was introduced as part of the Competition Act.

129. CANADIAN MERGER GUIDELINES, *supra* note 71, app. II.

130. *Id.*

However, claims of dynamic efficiencies are generally more difficult to measure, and the weight given to such claims will be qualitative in nature.¹³¹

The recent case of *Superior Propane*¹³² provides the most comprehensive analysis of the treatment of efficiencies in Canada. This case, which arose from the merger of two large Canadian propane companies, makes clear that Canadian competition law will not block horizontal mergers leading to high-market shares, provided that the economies of scale and scope and other quantitative efficiencies achieved as the result of the merger exceed the merger's anticompetitive effects. After the merger was challenged by the Canadian Commissioner in a hearing before the Tribunal, the merger parties argued that the merger would bring about substantial efficiency gains that would far outweigh any postmerger anticompetitive effects, primarily through the rationalization of distribution networks, head office functions, and other duplicative operations. The Tribunal allowed the merger to proceed and rejected the claim of the Canadian Commissioner that, as a matter of law, a "merger-to-monopoly" could never be saved by the efficiency defense.¹³³

Following two separate appeals by the Canadian Commissioner and a redetermination hearing by the Tribunal, the merger was permitted to proceed under the principle that efficiency was the paramount objective of the Canadian Competition Act. In the second appeal, the Federal Court of Appeal confirmed that the mere existence of a postmerger monopoly was not in and of itself an "anti-competitive effect" that would provide grounds to block the merger.¹³⁴

2. Signs of Reform in Canada

Notwithstanding the recent decisions in *Superior Propane*, the Canadian efficiency defense as it stands is not free from ambiguity in its application or execution. Nor is there a paucity of debate and suggested reform from some Canadian legal scholars and economists who have proposed alternative approaches to the analysis methods established for the efficiency defense in *Superior Propane*.¹³⁵

131. *Id.*

132. *Comm'r of Competition v. Superior Propane, Inc*, Registry Doc. No. 192b (Competition Tribunal, 2000), available at <http://www.ct-tc.gc.ca/english/cases/propane/192b.pdf>; *rev'd in part by* [2001] D.L.R.(4th) 130; *reh'g granted* Registry Doc. No. 238a (Competition Tribunal 2002), available at <http://www.ct-tc.gc.ca/english/cases/propane/0238a.pdf>; *aff'd by* [2003] D.L.R.(4th) 55 (Fed. Ct. App. 2003).

133. *Superior Propane*, Registry Doc. No. 192b, para. 418.

134. [2003] D.L.R. (4th) at 72.

135. For example, Professors Ross and Winter posit a "qualified total surplus rule."

The Canadian Commissioner decided not to appeal the Federal Court's second decision to the Supreme Court of Canada. Rather, he has sought legislative reform by supporting draft amendments to Section 96 in a private member's bill.¹³⁶ As it is currently drafted, the bill provides in effect that, in determining whether or not a proposed merger may prevent or lessen competition substantially, the Tribunal may have regard to whether the proposed merger is "likely to bring about gains in efficiency that will provide benefits to consumers, including competitive prices or product choices, and that would not likely be attained in the absence of the merger or proposed merger."¹³⁷ Thus, rather than having a "trade-off" between efficiencies and anticompetitive effects, efficiencies would be considered as part of the overall competitive assessment of the merger.

In his address to the Standing Committee on Industry, Science and Technology, reviewing the draft legislation, the Canadian Commissioner viewed the proposed amendments as consistent with the objective of promoting and maintaining fair competition that allows consumers to benefit from lower prices, product choice and quality service, and stated as follows:

The Bill seeks to ensure that consumers are not left out of the equation when considering mergers involving efficiency claims. It would also safeguard competition to the benefit of consumers and the Canadian economy. . . .

Bill C-249 would limit the application of the efficiency exception to ensure that consumers benefit from gains in efficiencies. This means that efficiencies could never be used to save a merger that resulted in the elimination of competition altogether.¹³⁸

under which the total surplus standard would apply except in rare cases where there is a clear and seriously regressive transfer away from "poor" consumers. Under this rule, the burden of proof would reside with the competition authority for demonstrating substantial lessening of competition and to the transaction parties for demonstrating efficiencies. If the total surplus standard is met, then the burden would shift back to the competition authority to prove a seriously regressive wealth transfer. *See generally* Thomas W. Ross & Ralph A. Winter, *The Efficiency Defense in Merger Law: Economic Foundations and Recent Canadian Developments*, Presented at the Competition Law Roundtable (Dec. 13, 2002) (on file with the Journal).

136. An Act to Amend the Competition Act, Bill C-249, 2nd Sess., 37th Parl., 2002, available at http://www.parl.gc.ca/PDF/37/2/parlbus/chambus/house/bills/private/c-249_3.pdf. The Bill was read a second time before the Senate in June 2003.

137. *Id.*

138. Konrad von Finckenstein, Commissioner of Competition, Speaking Notes for the Standing Committee on Industry, Science and Technology: Bill C-249—An Act to Amend the Competition Act, (March 31, 2003) at pp. 1,4, available at <http://strategis.ic.gc.ca/pics/ct/ct02543e.pdf>.

On the other hand, many in the Canadian business and legal community believe that the approach taken by the Canadian Competition Tribunal in the *Superior Propane* case properly reflects the intention of the Canadian Parliament in its objectives of promoting a more cost-effective and internationally competitive economy in Canada. The fact that gains in efficiencies which are real and specific to a merger may override certain anticompetitive effects is consistent with this broader national objective.

D. Comparison of the Treatment of Efficiencies in the United States, European Union, and Canada

It is clear that the antitrust authorities of the United States, European Union, and Canada have followed their own legislation and guiding policies in the treatment of postmerger efficiencies, resulting, at times, in markedly different approaches and principles. Appendix C provides a table illustrating the current differences among these three jurisdictions.

V. EFFICIENCIES: UNRESOLVED QUESTIONS AND POLICIES

Given the integral role of economics in antitrust analysis and the sentiments of enforcement officials such as Kolasky, it is surprising that (1) efficiencies continue to be treated with skepticism and hostility, and (2) fundamental issues regarding how to evaluate and factor efficiencies into the analysis remain. The balance of this paper focuses on issues raised by antitrust officials and scholars and offers suggestions as to how these issues may be resolved.

A. What Efficiencies Should Count?

This section discusses the types of efficiencies that should count in offsetting concerns about the competitive effects of a transaction. We recognize that certain categories of efficiencies are easier to verify and more likely to be substantiated and realized. We do not, however, favor the outright rejection of other categories of less certain efficiencies merely because they are less easily verified or occur less frequently. Rather, we suggest that, as with any other question of fact, the competition authorities (and, if applicable, the courts) weigh the evidence presented to determine whether or not to accept the specific efficiencies claimed by the parties in the specific transaction.

1. Merger Specificity

“Acquisitions have a unique potential to transform firms and to contribute to corporate renewal.”¹³⁹ Firms undertake acquisitions when their management believes it is the most profitable means of enhancing capacity, developing new knowledge or skills, or entering new product or geographic arenas.¹⁴⁰ The decision to undertake a major acquisition typically is part of a broader plan to achieve long-term company growth and reorganization objectives. The FCC and the U.S. 1997 Revisions focus on this unique potential by incorporating a requirement that the efficiencies claimed must be merger specific.¹⁴¹ The recently issued EU Draft Guidelines also require that efficiencies be merger specific.¹⁴²

Naturally, companies will assert that a merger is the most effective means of implementing their strategies. These assertions may raise considerable doubt in the minds of the regulators. For example, in *SBC/PacTel*, while the FCC noted that the merger would allow the firms to combine software development, customer service, billing, and collection systems, it nonetheless labeled these efficiencies “extremely difficult” to achieve without a merger, without giving reason why.¹⁴³ At the same time, the FCC suggested that joint research and development efforts “might well be achievable by a joint venture,” as could an improved Internet access business, a video services venture, and a coordination of international ventures.¹⁴⁴ Further, in *Bell Atlantic/NYNEX*, the FCC decided that the firms had failed to prove that the merger was necessary to create an effective long-distance competitor, to improve NYNEX’s service quality, or to improve the deployment of broadband services.¹⁴⁵

To impose a rigid merger specificity test to transactions has the potential of hampering a firm from obtaining, as expeditiously as possible, efficiencies that may be critical to the firm’s ability to compete (both domestically and internationally) and that may promote competition in the industry. After all, acquisitions are a major means by which firms achieve efficiencies.

139. PHILIPPE C. HASPELAGH & DAVID B. JEMISON, *MANAGING ACQUISITIONS: CREATING VALUE THROUGH CORPORATE RENEWAL* 3 (1991).

140. Paul A. Pautler, *Evidence on Mergers and Acquisitions 1-2* (Sept. 25, 2001), available at <http://www.ftc.gov/be/econwork.htm>.

141. *SBC/PacTel Order*, *supra* note 18, paras. 74-83.

142. EU Draft Guidelines, *supra* note 123, para. 90.

143. *SBC/PacTel Order*, *supra* note 18, para. 74.

144. *Id.* paras. 74-83.

145. *Bell Atlantic/NYNEX Order*, *supra* note 30, para. 168.

There may be a number of reasons why firms do not pursue efficiencies internally. For instance, a firm may not want to expand its infrastructure to take advantage of new technological efficiencies because the industry already has excess capacity or the associated costs would be prohibitive. That firm, however, could benefit from substantial efficiencies by merging with a competitor and consolidating its operations in the competitor's newer network. Similarly, although it may be theoretically possible to achieve many of the network effects through interconnection and the establishment of common standards, firms may not want to enter into a joint venture or contract due to high transaction costs associated with allocating the benefits of the arrangement between the firms. This is particularly true when the operations of the two parties are not perfectly symmetric, such that there may be competing internal uses for the network (e.g., cable telephony versus cable programming services on a cable network).

Various contracting options may not work as effectively as a merger due to the potential for opportunism that may occur in the context of agreements for the acquisition or lease of "knowledge." Many of the benefits of mergers involve the acquisition of knowledge, skills, and routines (e.g., marketing, customer service, technology, operations, best practices). Knowledge-based transactions can result in high transaction costs, as the creation of knowledge "often involves highly specific investments where quasi-rents could be expropriated in a spot market setting."¹⁴⁶ There are also difficulties in estimating the value of knowledge before it is seen. Yet after the knowledge has been disclosed, there is no need to pay for it. Further, knowledge assets often require continual investment to improve or maintain their value and may be subject to free-rider problems when independent companies attempting to "share" a brand name free-ride on investments of others in developing and maintaining the value of the brand name. All of these risky transaction costs may preclude the direct transfer or shared use of knowledge assets, making merger the preferred solution. In addition, corporate capabilities may be prone to dynamic transaction costs stemming from the fact that different people (and firms) possess different mental models based on their individual and established past experience, routines, and corporate culture. As firms do not share the same mental models, contracting for capabilities outside the firm may be more expensive than producing them inside the firm.¹⁴⁷

The intended achievement of scale economies can also be discouraged by the requirement for merger specificity. Acquiring firms can

146. Ellig, *supra* note 5, at 198.

147. *Id.*, at 199-200.

benefit from higher market share due to economies of scale in production, distribution, and marketing activities, as well as greater efficiency in future operating and investment decisions.¹⁴⁸ Simple scale economies may fail this test if it is strictly interpreted because one or both of the merger parties might be able to achieve greater scale on its own.¹⁴⁹ This is particularly true in industries either undergoing significant growth, or declining industries where excess capacity would exit the market following the transaction.

In our view, competition authorities should not force companies to choose less desirable means of achieving efficiencies or foregoing efficiencies because of some theoretical possibility that the firms could achieve those efficiencies absent a merger. The courts have—at the urging of the enforcement agencies—been very literal in their treatment of merger specificity, focusing on whether a firm could achieve the efficiencies absent the transaction and blocking transactions in which the court found efficiencies would occur.¹⁵⁰ Rather, we submit that the focus should be on whether there will be incremental cost savings from undertaking a transaction rather than attempting an internal expansion. Further, merger parties should not be limited to counting only those efficiencies that will be achieved over the short term.¹⁵¹ To the extent a longer time period is considered, the value of efficiencies can be suitably discounted to account for any risk and opportunity costs associated with the transactions.

Although, theoretically, some of the efficiency gains of a merger might be able to be achieved through other means (such as a service contract or lease), the mere theoretical possibility that such benefits could be achieved through means other than a merger should not be the benchmark for determining merger specificity.¹⁵² Indeed, the EU Draft

148. Alope Ghosh, *Increasing Market Share as a Rationale for Corporate Acquisitions 2* (May 2002), *available at* http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID314267_code0261600.pdf?abstractid=314267#PaperDownload.

149. Farrell & Shapiro, *supra* note 45 at 690; *see also* 4A PHILLIP E. AREEDA ET AL., *ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION*, 49-51 (rev. ed., Aspen 1998).

150. *FTC v. Tenet Health Care Corp.*, 186 F.3d 1045, 1054-55 (8th Cir. 1999); *FTC v. H.J. Heinz, Co.*, 116 F. Supp. 2d 190, 198-99 (D.D.C. 2000); *FTC v. Cardinal Health, Inc.*, 12 F. Supp. 2d 34 (D.D.C. 1998); *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1088-90 (D.D.C. 1997).

151. Some EU commentators, for instance, believe only a two-to-three-year time frame should be counted. The EU Draft Guidelines indicate that the longer efficiencies are projected into the future, the less weight the EC will assign to the efficiencies being brought about, and the benefits will be discounted accordingly. EU Draft Guidelines, *supra* note 123, para. 94. To date, there is no EU decision on this point.

152. The U.S. 1997 Revisions recognize that “the Agency will not insist upon a less restrictive alternative that is merely theoretical.” U.S. Merger Guidelines and U.S. 1997 Revisions, *supra* note 75, at 31.

Guidelines indicate that the EC will concentrate “on realistic and attainable alternatives rather than merely theoretical ones” and will consider “established industry practices.”¹⁵³ By way of comparison, in a Sherman Section 1 case, a court typically will not reject the countervailing justification (e.g., efficiencies) proffered by defendants merely because the restraint was not the “least restrictive means” of achieving the pro-competitive objective, provided that undertaking the arrangement to achieve this objective is deemed “reasonable.”¹⁵⁴ In contrast, some argue that under Clayton Section 7, “[e]fficiencies are not merger-specific if individual firms likely can *and will* achieve them without the necessity of merging (or comparable restrictions).”¹⁵⁵ This formulation of the test may be too restrictive if it requires showing that the specific firms at issue could not and would not have undertaken the efficiency-producing activity absent the merger. Accordingly, Chairman Muris (correctly, we submit) favors a test that focuses on whether the efficiencies are likely absent the merger, rather than on the question of whether the merger is reasonably necessary to achieve the efficiencies.¹⁵⁶

2. What Constitutes Cognizable Efficiencies?

Not all types of efficiencies are treated equally under the law (or, for that matter, by economists). Currently, there is an unwarranted bias toward accepting only those variable production cost savings¹⁵⁷ that can be achieved in a relatively short time frame. Although there is a greater risk of not achieving the efficiencies the longer the time horizon considered, such risk can be accounted for by applying an appropriate discount to the value attributed to those efficiencies, rather than blindly ignoring their potential benefits.

This section discusses each of the major categories of efficiencies and the current views regarding recognition of the category as a benefit, as well as some possible reasons for broadening the categories of cognizable efficiencies.

153. EU Draft Guidelines, *supra* note 123, at 29.

154. *See, e.g.*, United States v. Arnold, Schwinn & Co., 388 U.S. 365, 380-81 (1967) (examining whether restraint was “reasonably necessary”), *cited in* 2002 A.B.A. SEC. ANTITRUST L., ANTITRUST L. DEV. 76 n.413 (5th ed.).

155. Farrell & Shapiro, *supra* note 45, at 690.

156. Muris 1999 Article, *supra* note 77, at 732.

157. The EU Draft Guidelines indicate that cost efficiencies that lead to reductions in variable or marginal costs are more likely to be relevant than reductions in fixed costs because they are more likely to result in lower consumer prices. EU Draft Guidelines, *supra* note 123, at 29.

a. Productive Efficiency

Productive efficiency is the least controversial category of efficiencies. It is readily quantifiable and, for the most part, broadly accepted by economists and competition authorities alike. However, there remains some debate as to whether efficiencies should be counted if they can be achieved internally, such as by expanding facilities internally to achieve economies of scale. There are a number of practical reasons, however, why internal expansion can be significantly more costly. First, it might be slower to occur due to the need to construct facilities, introduce new technologies, etc. Second, adding new capacity in a stable or declining demand environment may place downward pressure on price, thereby making such expansion unprofitable. Third, adding new capacity may result in social waste to the extent that duplicate resources at the acquired firm subsequently may be scrapped.¹⁵⁸

b. Distribution and Promotional Efficiencies

The U.S. 1997 Revisions are silent regarding the acceptability of distribution and promotion efficiencies. (The Canadian Merger Guidelines, on the other hand, expressly acknowledge the acceptance of efficiencies relating to distribution and advertising activities.¹⁵⁹) While the FTC Global Staff Report viewed these types of efficiencies as “less likely to be substantial . . . and often likely to be difficult to assess,”¹⁶⁰ Chairman Muris has noted that in the cost structure of consumer goods, promotion plays an important role, particularly since the larger market share may be needed to achieve minimum efficient scale.¹⁶¹ Prior to his appointment as FTC Chairman, he suggested that the government recognize these kinds of efficiencies.¹⁶² We submit there is no reason that distribution and promotional efficiencies should not be counted.

c. Dynamic or Innovative Efficiency

While productive efficiencies are achieved from producing goods at lower cost or of enhanced quality using existing technology, innovative efficiencies “are the cost saving or product enhancement gains achieved

158. See William J. Kolasky, *The Role of Efficiencies in Merger Review*, ANTITRUST, Fall 2001, at 82.

159. *Id.*

160. FTC Global Report, *supra* note 74, at 33.

161. J. HOWARD BEALES & TIMOTHY J. MURIS, STATE AND FEDERAL REGULATION OF NATIONAL ADVERTISING, 7-10 (1993) (recognizing the importance of these economies in consumer goods markets); Muris 1999 Article, *supra* note 76, at 734.

162. Muris 1999 Article, *supra* note 76, at 734.

from the innovation, development, or diffusion of new technology.”¹⁶³ Especially in high-tech industries, “much of the focus of efficiency analysis will be on R&D efficiencies. R&D efficiencies offer great potential, but because they tend to focus on future products, there may be formidable problems of proof.”¹⁶⁴ The FTC Global Report acknowledged that “innovation efficiencies may make a particularly powerful contribution to competitive dynamics, the national R&D effort, and consumer (and overall) welfare.”¹⁶⁵

As a general proposition, society benefits from conduct that encourages innovation to lower costs and develops new and improved products. Thus, Kolasky indicated in March 2002, “productive and dynamic efficiencies are at least as important as static allocative efficiency in promoting economic growth.”¹⁶⁶ The European Union appears to recognize this type of efficiency as well, at least to the extent that it results in real or improved products that benefit consumers.¹⁶⁷ Yet, the U.S. 1997 Revisions provide that efficiency claims “relating to research and development are potentially substantial but are generally less susceptible to verification and may be the result of anti-competitive output reductions.”¹⁶⁸ Just because they are difficult to quantify and verify, however, does not mean that such efficiencies should be ignored. Dynamic efforts should be taken into account even though they do not necessarily lead to price reductions¹⁶⁹ or their effects are not seen in the short term.

d. Transactional Efficiency

An acquisition can foster transactional efficiency by eliminating the middle man (and, therefore, “double marginalization”). United States, and presumably European Union, antitrust law has not always been sensitive to the role of mergers in reducing these costs. In contrast, Canada has recognized the benefit of increased production-related efficiency resulting from integrating activities within the merged entity that were previously performed by third parties. (Attainment of these gains generally involves a

163. Joseph F. Brodley, *Proof of Efficiencies in Mergers and Joint Ventures*, 64 ANTITRUST L.J. 575, 579 (1996) (footnote omitted).

164. David Balto, *The Efficiency Defense in Merger Review: Progress or Stagnation?*, ANTITRUST, Fall 2001, at 74, 76.

165. FTC Global Report, *supra* note 74, at 32.

166. William J. Kolasky, *Comparative Merger Control Analysis: Six Guiding Principles for Antitrust Agencies—New and Old*, Address at the International Bar Association Conference on Competition Law and Policy in a Global Context (Mar. 18, 2002), available at <http://www.usdoj.gov/atr/public/speeches/10845.htm>.

167. EU Draft Guidelines, *supra* note 123, at 29.

168. U.S. Merger Guidelines and U.S. 1997 Revisions, *supra* note 75, at 37.

169. Ilzkovitz & Meiklejohn, *supra* note 6, at 24.

reduction in transaction costs associated with matters such as contracting for inputs, distribution, and services.¹⁷⁰⁾

In general, market participants design business practices, contracts, and organizational forms to minimize transaction costs and reduce exposure to opportunistic behavior (e.g., holdups). Joint ventures and common ownership can help align firms' incentives and discourage shirking, free riding, and opportunistic behavior that can be costly and difficult to police using arm's-length transactions. Transactional efficiencies, therefore, should be recognized as benefits from a merger.

e. Network Efficiencies

Notwithstanding that network effects can create substantial, if not difficult to quantify, efficiencies, mergers that consolidate consumer penetration for one of the networks can also create significant entry barriers. First, once customers select a particular network, any substantial nonrecoupable investment that the individual consumers make can have a "lock-in" effect that will deter consumers from switching to a rival system, even if that system is superior. Second, a significant combined penetration rate can have a tipping effect, causing certain consumers that have not already chosen a network to go with the larger entity. Third, the larger merged firm may alter its willingness to deal with rivals on fair, or any, terms postmerger due to changed ability and incentives to foreclose others from access to customers. As a result, network externalities can be seen to weaken competition by incumbent firms and create entry barriers for new competitors.¹⁷¹

A concern about network externalities having an anticompetitive effect was the prime reason that the DOJ cleared the WorldCom/MCI transaction only after the parties committed to divest Internet MCI (MCI's Internet backbone service business) to Cable & Wireless.¹⁷² Prior to the merger, there were several providers of nationwide Internet backbone services, with no one company accounting for a majority of the customers or providing complete network coverage. As a result, the major providers had agreed to interconnect with peers in order to provide complete network coverage. In the absence of the divestiture, the merger would have combined two of the top four Internet backbone service providers, and

170. CANADIAN MERGER GUIDELINES, *supra* note 71, app. II. Indeed, distribution efficiencies have played significant roles in assessing the overall effects of a merger.

171. Timothy J. Muris, *The FTC and the Law of Monopolization*, 67 ANTITRUST L.J. 693, 719, 723 (2000).

172. Press Release, DOJ, Justice Department Clears WorldCom/MCI Merger after MCI Agrees to Sell its Internet Business (July 15, 1998), *available at* <http://www.usdoj.gov/opa/pr/1998/July/329at.html>.

MCI/WorldCom would arguably no longer have had the same incentive to interconnect with others to offer backbone services (or could have degraded interconnection services).¹⁷³ In addition, the merged firms' increased scale and share of the backbone volume (i.e., more than fifty percent of the current subscribers) might have had a tipping effect, thereby further increasing the advantages of MCI/WorldCom in attracting customers and hampering the ability of others to compete.

f. Technological and Standardization Efficiencies

As stated above, standardization of technology resulting from the combination of networks can generate significant social gains. However, since many merger control laws do not permit the consideration of any postmerger efficiencies that would occur absent the merger, one must determine whether the adoption of a common standard would have been achieved in the absence of the merger.¹⁷⁴

g. Procurement, Management and Capital Cost Savings

The U.S. 1997 Revisions place purchasing, management, and capital cost savings in the category of efficiencies that "are less likely to be merger-specific or substantial, or may not be cognizable for other reasons."¹⁷⁵ Indeed, some commentators have argued that certain types of cost savings should be accorded greater weight than others, owing to issues of the difficulty of evidentiary proof.¹⁷⁶ For example, savings arising from consolidating management or administrative functions are thought to be of lower value than those that might arise from economies of scale. Former Canadian Bureau economist Margaret Sanderson observed:

In the Bureau's experience, administrative and corporate overhead savings are just as likely to be measurable as plant-level production savings. However, certain production efficiencies are generally more easily verifiable than others and are certainly easier to verify than dynamic efficiencies. Yet this has not resulted in according a differing status to a class of efficiencies in the trade-off analysis; rather, a probability weighting (or range of weightings) is assigned to the

173. The abandoned MCI WorldCom/Sprint merger also raised the same concerns since Sprint is a major Internet backbone company. The merger was abandoned after the DOJ announced an intention to seek a preliminary injunction to block. *Complaint, United States v. WorldCom* (D.D.C. 2000) (No. 00-CV-1526), available at <http://www.usdoj.gov/atf/cases/f5000/5051.pdf>.

174. Schwindt & Globerman, *supra* note 7.

175. U.S. Merger Guidelines and U.S. 1997 Revisions, *supra* note 75, ch. 4.

176. Margaret Sanderson, *Efficiency Analysis in Canadian Merger Cases*, Remarks at the Federal Trade Commission Hearings on Global and Innovation-Based Competition (Nov. 2, 1995), available at <http://www.ftc.gov/opp/global/sandersn.htm>.

various cost claims. In this way the less likely cost savings are accorded less weight without discarding a class or type of efficiency claim.¹⁷⁷

The EC also appears to be hostile to this category of savings. In *Aerospatiale-Alenia/de Havilland*, for instance, the management cost savings identified by the parties were rejected as not merger specific: “These cost savings would not arise as a consequence of the concentration *per se*, but are cost savings which could be achieved by de Havilland’s existing owner or by any other potential acquirer.”¹⁷⁸ Nevertheless, we submit that such cost savings should not be summarily dismissed since in the real world they do occur and can be significant in magnitude.

i. Procurement Savings

A Booz-Allen & Hamilton report indicated that procurement synergies often comprise fifty percent of the total value of all synergies realized in a merger.¹⁷⁹ Not surprisingly, therefore, in the business world, procurement savings often are a touted source of merger savings, with “[p]rocurement consistently generat[ing] the bulk of near-term savings in merger integration efforts.”¹⁸⁰ For instance, increased volume typically results in lower unit costs. In addition, combining best practices in sourcing approaches and purchasing practices can result in significant cost savings.¹⁸¹ “Procurement savings are particularly persuasive where the reduction in the number of buyers or the streamlining of the buying process will reduce the costs of the suppliers and these reduced costs will be passed on to consumers.”¹⁸² It should be noted, however, that the Canadian Competition Act does not permit efficiency claims that merely represent “a redistribution of income between two or more persons,” including a redistribution of income to suppliers extracted as reductions through the increased bargaining leverage of the merged firm.¹⁸³

177. *Id.*

178. Commission Decision of Oct. 2, 1991 Declaring the Incompatibility with the Common Market of a Concentration (Case No. IV/M053-Aerospatiale-Alenia/de Havilland) 1991 O.J. (L 334) 42, 59 (emphasis added).

179. DORIAN SWERDLOW ET AL., MANAGING PROCUREMENT THROUGH A MERGER: CAPTURING THE VALUE OF THE DEAL 2 (Booz-Allen & Hamilton, Viewpoints on Mergers, Acquisitions, and Intergration, Aug. 2001), available at <http://extfile.bah.com/livelink/livelink/87995/?func=doc.Fetch&nodeid=87995>.

180. *Id.* at exec. summary.

181. James P. Andrew & Michael Knapp, Boston Consulting Group, *Maximizing Post-Merger Savings from Purchases* (July 1, 2001), available at http://www.bcg.com/publications/files/Max_PostM_Savings_from_Purch_Apr_01_ofa.pdf.

182. Balto, *supra* note 164, at 77.

183. R.S.C., ch. 19 (2nd Supp.) § 96(3) (1985) (Can.).

It is ironic that antitrust officials are skeptical regarding obtaining procurement efficiencies given that, in a few recent U.S. cases, the premise for the competition concern was the market power that the combined firm would have in the purchase of a particular input (i.e., monopsony power).¹⁸⁴ Röller, Stennek and Verboven recognize that purchasing cost savings can be achieved in a merger. They suggest:

To assess the social effects from increased bargaining power toward suppliers, it is important to know the degree of power at the supplier side. If there is little power in the supplier side, the increased bargaining power of the merging firm may be socially harmful. If, however, the increased bargaining power forms a form of countervailing power to an already strong supply side, then the private benefits from the merging firm may coincide with the social benefits.¹⁸⁵

As reflected in the paucity of government challenges on these grounds, monopsony power rarely exists, or is sustained, in markets. As David Balto indicates, “[p]rotecting the ability to secure lower prices is an important goal of the antitrust laws. . . . [Courts] should be cautious—reluctant to condemn too speedily—an arrangement that on its face appears to bring low price benefits to the consumer.”¹⁸⁶ Accordingly, absent monopsony issues, the competition authorities should permit parties to assert procurement savings as benefits from the transaction.

ii. Managerial Savings

Although antitrust enforcement officials may discount managerial efficiencies as not being merger specific and being a fixed cost less likely to be passed on to consumers in the short term,¹⁸⁷ the financial literature recognizes the importance of the “market for corporate control” (acquisitions) as a means of weeding out bad management and moving

184. *United States v. Aetna, Inc.*, 1999-2 Trade Cas. (CCH) 72,730; *United States v. Cargill, Inc.*, 2000-2 Trade Cas. (CCH) 72,966. *See also* Susan M. Davies & Marius Schwartz, *Monopsony Concerns in Merger Review*, CLAYTON ACT NEWSLETTER (Am. Bar Ass’n, Section of Antitrust Law), Winter 2002, at 19.

185. LARS-HENDRICK RÖLLER ET AL., EFFICIENCY GAINS FROM MERGERS (Research Inst. of Indus. Econ., Working Paper No. 543, 2000) available at <http://ideas.repec.org/p/lhs/iuiwop/0543.html>.

186. Balto, *supra* note 164, at 78 (quoting *Kartell v. Blue Shield*, 749 F.2d 922, 931 (1st Cir. 1984)).

187. Joseph Kattan, *Efficiencies and Merger Analysis*, 62 ANTITRUST L.J., 513, 520 n.36 (1994).

assets to their highest valued uses.¹⁸⁸ FTC Commissioner Thomas Leary indicates:

Efficiencies of [the kind realized by General Motors], whether they are called innovation or managerial economies, are probably the most significant variable in determining whether companies succeed or fail—or in determining whether certain more specific merger efficiencies are achieved or not. Yet, we do not overtly take them into account when deciding merger cases.¹⁸⁹

In large public corporations particularly, a failure of management to maximize the profits of the corporation leads to internal inefficiency, sometimes referred to as “x-inefficiency.” It is the recouping of some of these inefficiencies that motivates some transactions, particularly hostile transactions. It is through resource sharing and the transfer of functional and general management skills that capability transfer takes place in acquisitions.¹⁹⁰ Functional skill and general management skills transfer occurs when one firm improves its capabilities by obtaining functional skills from another firm. Examples include advanced manufacturing process skills, knowledge of an additional distribution channel, and cutting-edge research,¹⁹¹ as well as corporate leadership and human resource management. These managerial skills are, perhaps, more transferable within same or complementary industries than between different product or service industries.¹⁹² In the right circumstances, for example, when a merger facilitates the use of superior know-how, such efficiencies should be recognized. Professor Scherer notes that “[i]t is a fact of life that some managements are better at reducing costs than others. To ignore efficiencies that result from superior management is to close one’s eyes to an important component of reality.”¹⁹³

Similarly, in a November 2002 ABA speech, Commissioner Leary recognized:

[I]nnovation or managerial [efficiencies] . . . are probably the most significant variable in determining whether companies succeed or fail.

188. Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

189. Thomas B. Leary, *Efficiencies and Antitrust: A Story of Ongoing Evolution*, Address at the Fall Forum of the ABA Section of Antitrust Law (Nov. 8, 2002), available at <http://www3.ftc.gov/speecheds/leary/efficienciesandantitrust.htm>.

190. HASPELAGH & JEMISON, *supra* note 139, at 29.

191. *Id.* at 30-31.

192. *See id.* at 126. This is in part due to a failure to appreciate and understand the subtleties of industry and firm context. Further, managerial efficiencies are extremely difficult to verify, and almost all business executives think they can run the target company better than the target’s current team.

193. F.M. Scherer, *Some Principles for Post-Chicago Antitrust Analysis*, 52 CASE W. RES. L. REV. 5, 21 (2001) [hereinafter *Scherer Case Western Article*].

. . . Yet, we do not overtly take them into account when deciding merger cases.

We tend to ignore the less-tangible economies in the formal decision process because we simply do not know how to weigh them.¹⁹⁴

Indeed, there are no reported instances in which any of the competition authorities studied expressly recognized managerial efficiencies in the merger review and permitted the transaction to proceed on that basis. Commissioner Leary suggests that one solution is to evaluate the track record of the acquirer and the key employees of the target company to determine whether they are likely to manage the company efficiently.¹⁹⁵ Commissioner Leary further suggests that even if the staff cannot quantify the value of such managerial efficiencies, such arguments should provide the staff with a noncompetitive explanation for the transaction.¹⁹⁶

iii. Capital Cost Savings

A related category of efficiency disfavored by the antitrust enforcement agencies relates to capital-raising efficiencies, presumably because of the relatively fixed nature of these costs. Research reveals evidence of substantial efficiencies in capital-raising costs as one of the most persistent advantages of corporate size. Empirical work indicates that companies with more than \$1 billion in assets enjoy, on average, about a six percent lower borrowing cost than firms with \$200 million in assets. Moreover, \$200 million companies enjoy a borrowing cost advantage of approximately twelve percent over \$5 million companies.¹⁹⁷ A more recent study finds empirically that firms can increase their financial leverage post-consummation because of an increase in debt capacity,¹⁹⁸ thereby facilitating quicker expansions. Yet, the U.S. and EU competition authorities are unwilling to count such savings.

As with productive scale economies, these pecuniary savings should also be recognized because they can dramatically improve the firm's cost position and, therefore, its competitiveness in the marketplace. To the extent that these cost savings are likely to be passed on to consumers only over the long term and a consumer welfare standard is deployed, the value of these savings can be discounted appropriately.

194. Leary, *supra* note 189.

195. *Id.*

196. *Id.*

197. F.M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 126 (3rd ed. 1990).

198. Aloke Ghosh and Prem C. Jain, *Financial Leverage Changes Associated with Corporate Mergers*, 6 J. CORP. FIN. 377 (2000).

B. What Welfare Standard Should Be Applied?

The debate continues regarding whether “allocative efficiency”¹⁹⁹ or consumer surplus should be the ultimate goal of competition laws. The debate over the proper standard is part of the greater political debate over whether the ultimate goal of antitrust laws is consumer welfare or efficiency maximization. Nevertheless, it is useful at a minimum to understand the merits and limitations of the full range of standards—regardless of whether or not one particular jurisdiction has the political appetite for adoption of the standard.

1. Price Standard and Consumer Surplus Standard

Under the price standard, proven efficiencies must prevent price increases in order to reverse the potential harm to consumers. Efficiencies are considered as a positive factor in merger review, but only to the extent that at least some of the cost savings are passed on to consumers in the form of lower prices.

The consumer surplus standard is a refined variation of the price standard. Under the consumer surplus standard, a merger will be permitted to proceed where the consumer gains in efficiency (i.e., the resource savings in costs) exceed the total loss of consumer surplus. However, while the lost consumer surplus is taken into account, the corresponding profit gain to seller/shareholders is not and, therefore, does not offset the loss in consumer surplus. In other words, no benefit is recognized from seller/shareholder profits, even when society may benefit from such profits.

Advocates of the total surplus standard argue that the consumer surplus standard is not consistent with traditional welfare theory: by assigning a zero weight to seller/shareholder profits, the standard, in effect, disregards the maximization of social welfare, i.e., that gains to seller/shareholders can be socially positive. By assigning the same weight to all consumers, the consumer surplus standard treats all consumers alike, therefore protecting all consumers, even when some may be better off than the shareholders.

In the United States, courts and the FCC currently favor a form of consumer surplus standard.²⁰⁰ In Canada, at least for the time being, a balancing weights approach has been adopted. In the European Union, to the extent efficiencies have been recognized, it has been under this consumer surplus standard that (otherwise objectionable) transactions have

199. “Allocative efficiency” is sometimes referred to as “total welfare” or “total surplus.”

200. Leary, *supra* note 189.

been permitted. Monopoly overcharges, after all, represent a real harm to consumers. Consumer surplus proponents believe that “[a]llocative efficiency claims are seldom to be advanced in justification of a merger.”²⁰¹ Under the consumer surplus standard or the price standard, there must be direct welfare of purchasers in the relevant market count. Any merger that raises price, without regard to magnitude of any associated savings, reduces consumer welfare. Thus, under this approach, efficiencies are only cognizable if passed on to consumers in the form of price reductions.²⁰² One problem with the passing-on requirement is the relationship between presumed anticompetitive conduct and likely efficiencies.

Apart from whether the goals of antitrust laws should prohibit wealth transfers from consumers to producers, there appears to be a strong economic basis for eliminating the passing-on requirement. Former FTC Chairman Robert Pitofsky indicated that the passing-on requirement is a “killer qualification” since it requires a nearly perfect competitive market, in which case, he posits that the transaction would not be a concern in the first place.²⁰³ Accordingly, Pitofsky concludes that the passing-on requirement “prevent[s] consideration of an efficiency defense in most cases where it would make a difference.”²⁰⁴ More recently, Commissioner Leary indicated that he “do[es] not favor any separate requirement that pass-on of efficiency savings be shown.”²⁰⁵ The Canadian Competition Tribunal reached the same conclusion when it flatly rejected the consumer surplus standard in the Superior Re-determination Decision because its adoption in all cases would generally make the efficiency defense unavailable under the Competition Act.²⁰⁶

2. Total Surplus Standard

The total surplus standard, like the consumer surplus standard, is applicable to a merger that may result in both higher prices and lower costs. As mentioned above, total surplus is the sum of consumer and producer surplus. Consumer surplus is the difference between what consumers are

201. Mark N. Berry, *Efficiencies and Horizontal Mergers: In Search of a Defense*, 33 SAN DIEGO L. REV. 515, 544 (1996).

202. Kattan, *supra* note 187, at 519. Kattan says that this consumer surplus standard, with its distributional consequences, is supported by legislative history. *Id.* at 528 n.63. Most commentators have interpreted the U.S. 1997 revisions as adopting the “consumer welfare” approach.

203. Robert Pitofsky, *Proposals for Revised United States Merger Enforcement in a Global Economy*, 81 GEO. L.J. 195, 207 (1992).

204. *Id.* at 208.

205. Leary, *supra* note 189, at 9.

206. *Comm’r of Competition v. Superior Propane, Inc.*, [2001] D.L.R.(4th) 130.

willing to pay for a product and the amount they are required to pay, and producer surplus is the difference between a firm's revenues and its economic costs (i.e., its economic profits). If the result of a merger is to raise the price of the relevant product without improving quality, consumer surplus decreases *ceteris paribus*; if the merger is profitable, producer surplus increases. Some of the increase in producer surplus arises from the decrease in consumer surplus. This is called the transfer of wealth or welfare, as an increase in price causes wealth to be distributed from the consumer to the producer. Under the total surplus standard, welfare transfers from consumers to shareholders are not taken into account. Rather, the anticompetitive effect of the merger is measured solely by the deadweight loss to society.²⁰⁷ Therefore, under this standard, efficiencies need only exceed the deadweight loss to permit an otherwise anticompetitive merger to proceed.

Perhaps the arguments for the total surplus standard are best summarized by Professor McFetridge:

The consumer surplus standard will allow mergers that hurt consumers as consumers and forbid mergers that benefit the economy as a whole. It does not distinguish between the transfer of wealth and the destruction of wealth. The consumer surplus standard is acknowledged to have no basis in welfare economics.²⁰⁸

Unlike a consumer surplus approach, a total welfare standard assigns an equal weight both to the loss in consumer surplus and the corresponding gain to shareholders. In other words, the transfer of wealth on surplus is viewed as "neutral."²⁰⁹ The rationale for a total surplus standard is grounded in the belief that the wealth transfer effects of mergers are neutral due to "the difficulty of assigning weights to certain effects *a priori* based on who is more deserving of a dollar."²¹⁰ In contrast, under a consumer-

207. Michael Trebilcock & Ralph A. Winter, *The State of Efficiencies in Canadian Merger Policy*, CAN. COMP. REC., Winter 1999-2000 at 106, 106.

208. D.G. McFetridge, *Efficiencies Standards: Take Your Pick*, CAN. COMP. REC., Spring/Summer 2002, at 45, 55.

209. Ross and Winter are critical of the neutrality assumption and argue that the fact that all individuals in the economy consume, and therefore can be *labeled* consumers, does not in itself mean that a transfer from one group of individuals to another can be treated as neutral. Rather, a transfer is "welfare-improving" if it transfers wealth from more wealthy to less wealthy individuals. *A priori*, it cannot be said that consumers in a market are of the same wealth as shareholders. For example, in some markets—ski resorts, airlines, private jets, spa services, luxury goods in general—consumers are relatively wealthy, whereas in other markets, consumers may be less wealthy than shareholders. Ross & Winter, *supra* note 135, at 37-38.

210. Margaret Sanderson, *Competition Tribunal's Re-determination Decision in Superior Propane: Continued Lessons of the Value of the Total Surplus Standard*, CAN. COMP. REC., Spring/Summer 2002, at 1, 1. The difficulty in making these interpersonal utility comparisons occurs in both a theoretical sense and a practical sense. From a

oriented approach, the focus is on ensuring that consumers obtain a direct share of the wealth transfer rather than being indifferent to whether consumers or shareholders obtain the benefits. It is, of course, theoretically possible to assign differential weights to consumers and producers, as employed by the balancing weights approach discussed below.

One factor to consider is whether, even assuming that the total welfare standard is politically unacceptable generally, there may be reasons to adopt the standard in certain limited industries, such as telecommunications. Given the network characteristics that exist in the industry, it is clear that network externalities arise from the increased usage of the network. Indeed, the most efficient network might be the monopoly network. Although the optimal solution *might* be to permit such consolidation in exchange for continued regulatory oversight by, for instance, the FCC, it is unclear whether today's political fora, which have embraced competition over regulation, would even contemplate such an arrangement.

3. Balancing Weights Approach

The redistribution of income resulting from a transaction that increases a firm's market power normally will have a negative effect on consumers (through loss of consumer surplus) and a corresponding positive effect on seller/shareholders (through excess profit). The balancing weights approach attempts to find a balance between these redistributive effects by assigning relative weights to each of the losses to consumers and gains to sellers/shareholders. This approach was endorsed by the Canadian Federal Court of Appeal in *Superior Propane* and subsequently applied in principle by the Tribunal.²¹¹

Whether these two effects offset each other in any capacity is a socioeconomic decision that requires a value judgment depending on the individual characteristics of those consumers and shareholders affected by the merger.²¹² In some cases, the redistribution of income may be seen as

theoretical point of view, there is often no basis for valuing one consumer's welfare over another's welfare. From a practical point of view, it is often difficult to trace the beneficiaries of increased profits, which are largely pension funds.

211. *Comm'r of Competition v. Superior Propane, Inc*, Registry Doc. No. 192b (Competition Tribunal, 2000), available at <http://www.ct-tc.gc.ca/english/cases/propane/192b.pdf>. Prior to *Superior Propane*, the total surplus standard had been the proper test since the early 1990s in Canada and had been adopted in the Canadian Merger Guidelines.

212. *Id.* paras. 431-437. The Canadian Competition Tribunal initially rejected the balancing weights approach because, *inter alia*, it considered that the members of the Tribunal were not qualified to make assessments on the social merit of competing societal interests. *See id.* para. 431. Further, the Tribunal was of the view that the adoption of the balancing weights approach might result in inconsistent decisions based on the individual

neutral. In other cases, it will be seen as socially positive or socially negative. The difficulty in this approach, of course, is determining the appropriate weights to assign to each of these societal groups. It allows for a degree of subjectivity we believe should be minimized if it is to be a useful and relatively predictable means of assessment.

C. What Standard of Proof Should Be Imposed?

The expected value of an efficiency is a function of both the magnitude and the likelihood of the efficiency, and, if a low expected value is sufficient to outweigh the competitive risks of a transaction, then an efficiency of lesser magnitude or lower probability, or both, may meet the merging parties' burden. Part of the skepticism about efficiencies arises from the difficulties in gauging future events with precision. Conrath and Widnell capture the suspicion with which evidence of efficiencies is evaluated:

The information relevant to evaluating claims of efficiencies from specific mergers is entirely within the control of the merging firms. They have an incentive to overstate or fabricate information to obtain a benefit—market power. It is easy to make glib efficiency claims; it is harder to deliver on them. Perhaps as a result of this phenomenon, there is, in the authors' experience, rarely a merger that attracts the attention of an enforcement agency whose proponents do not claim that their particular merger creates unique efficiencies that will be passed on to consumers and cannot be achieved without the merger.

The firms and individuals that make overstated, excessively optimistic, or fanciful efficiencies claims in merger litigation do not have to live with all the consequences of being wrong about efficiencies. Suppose that an anticompetitive merger is approved on the prediction that efficiency price decreases will outweigh anticompetitive price increases. If the efficiencies claims turn out to be overstated, and the anticompetitive price increases occur, the net effect is anticompetitive higher prices. . . .

Firms have other disincentives that discourage the firm from overstating efficiency claims. . . . On balance, however, it is always appropriate to evaluate efficiency claims with an eye on whether there is a connection between truth and consequences.²¹³

(and perhaps subjective) views of the members of the Tribunal. *Id.* para. 433.

213. Craig W. Conrath & Nicholas A. Widnell, *Efficiency Claims in Merger Analysis: Hostility or Humility*, 7 GEO. MASON L. REV. 685, 696-97 (1999). Muris notes that "[t]he Conrath & Widnell article . . . illustrates the continued hostility of career government attorneys. In reading this Article, it is difficult to reject the conclusion that the authors believe that the Guidelines are just fine—the 1968 Guidelines, that is, which rejected consideration of efficiencies in most cases." Muris 1999 Article, *supra* note 76, at 751 n.132 (citation omitted).

The credibility of efficiencies claims depends on verification of the claims and the strength of the evidence overall. The most common sources of evidence are a company's internal plans and cost studies, as well as public statements.²¹⁴ To the extent that the motive for a transaction is achievement of efficiencies, some engineering and financial evaluations may be available. Depending on the extent of due diligence and the number of people within each company who are involved in the transaction pre-announcement, there may be only preliminary and rough estimates of such cost savings pre-transaction.

Moreover, the lack of detailed documents does not mean that the transaction parties have not legitimately considered and relied upon the potential efficiencies in their business decisions regarding the transaction. FTC Bureau of Economics Director David Scheffman explained:

Economists are generally frustrated by the paucity of company documents laying out merger efficiencies. This experience has helped develop agency economists' skepticism about merger efficiencies. It is unclear, however, whether agency economists recognize that they would generally find a paucity of company documents dealing with *any* major strategic investment decision that would have effects far into the future. Companies do not generally write reports or analyses in anything like the form that an economist would create. The business of business is taking risks, not writing reports.²¹⁵

Nevertheless, to the extent that there are internal plans and cost studies developed by the merger parties, they should be considered by the antitrust officials, regardless of whether they were compiled before or after a transaction's announcement.²¹⁶

In addition, industry studies of size-related cost efficiencies may be available from third-party consultants or in economics and engineering literature. Testimony from industry, accounting, and economic experts also can be useful. Similarly, information regarding past merger experience of merging firms or other firms in the industry can be useful indicators of the likely cost savings from the proposed merger.

214. Publicly-traded companies, however, may be conservative regarding their estimates regarding potential efficiencies due to the potential for the marketplace to punish severely (through the equity trading value) a company that fails to meet its claims; rather, firms may be rewarded in the long term if they lowball their claims and then are able to tout achievements that exceed the target.

215. David T. Scheffman, *Making Sense of Mergers*, 38 ANTITRUST BULL. 715, 723 (1993).

216. Gary L. Roberts & Steven C. Salop, *Efficiencies in Dynamic Merger Analysis*, WORLD COMPETITION L. & ECON. REV., June 1996, at 5, 15. The U.S. antitrust authorities have tended to be skeptical of documents and studies developed after a transaction is announced, even though, there may be practical reasons why pre-announcement documents do not exist or are in a preliminary state. *Id.*

Professor Ellig suggests that there are four reasons to be confident that the efficiencies submitted by telecommunications firms, at least in FCC proceedings, should be reliable: (1) Because “the materials submitted are sworn statements under penalty of perjury . . . it is likely that the claims at least represent a plausible version of firms’ current perceptions of the mergers’ likely effects.” (2) “[T]he merging firms face strong incentives to understate the expected quantum of cost savings and other efficiencies.” These incentives are a product of FCC regulatory proceedings that “give a variety of parties, including competitors, suppliers, labor unions, business customers, consumer organizations, and other public interest groups an opportunity to argue that they should receive some of the gains from the merger.” Merger parties can “reduce their exposure to such demands by downplaying the size of the efficiencies.” (3) “Merging companies frequently commit to the projected cost savings and revenue enhancements by announcing them to underwriters and investment analysts and basing managerial compensation on achievement of the goals.” (4) “Several mergers—notably SBC/PacTel, Bell Atlantic/NYNEX, and an earlier merger of Bell Atlantic and NYNEX’s cellular ventures—have produced their expected cost savings on schedule.”²¹⁷

Although review of the existing evidence may not eliminate all doubt regarding (1) whether the efficiencies will indeed be achieved and (2) the magnitude of savings that will actually be realized, this is not a reason to conclude that the efficiencies should not be counted at all or should be given less weight than evidence relating to market power. The same difficulties and uncertainties can be cited when trying to predict any future eventualities, including the effects of concentration and market power. Given the societal costs of blocking a transaction that may produce significant synergies, enforcement officials should not adopt any presumptions against efficiencies, but rather, they should evaluate the merits of such claims just as they would weigh the likelihood of anticompetitive efforts. While it is true that forecasting synergies from a merger is an uncertain and difficult exercise, this is often no more speculative than forecasting the competitive response of rivals or poised entrants to possible price increases by the merged entity. Further, a stricter evidentiary burden also might negate the availability of the efficiency exception. Neil Campbell concurs with this argument when he observes that “[f]uture efficiency gains need not (and usually cannot) be established conclusively. . . . The same standard is used in the anti-competitive threshold where it appears to mean probable. There is no reason to assign a

217. Ellig, *supra* note 5, at 207-08 (citations and footnotes omitted).

different meaning in the efficiency gains context.”²¹⁸ The burden of proof imposed on transaction parties claiming an efficiency defense should be the same, less than absolute, standard.

D. How Should Efficiencies Be Factored into the Analysis?

Debate remains regarding how efficiencies should be included in M&A analysis. There appears to be, at least in the United States, an unwritten “absolute rule” that recognizes efficiencies, for enforcement purposes only, on a sliding scale as compared to postmerger market concentration levels.²¹⁹ Simply stated, this rule suggests that the lower the concentration levels, the more likely antitrust agencies will factor into the analysis the efficiencies’ benefits of a transaction.²²⁰ For transactions raising higher concentration concerns, this approach discounts efficiency claims. Moreover, as indicated in the U.S. 1997 Revisions and in recent court decisions, at some point, concentration may reach a level at which efficiencies almost never count (e.g., monopoly or near monopoly, or, as proposed by former FTC Chairman Pitofsky, where the combined company would hold more than thirty-five percent of the market).²²¹ Indeed, efficiencies have never been the primary reason that the U.S. antitrust authorities lost a merger challenge.²²²

Similarly, the use of structural market indicators appears to correspond to the current EU model, to the extent the European Union has not explicitly recognized an efficiency defense, but rather takes the likelihood of efficiencies into account by using a relatively high threshold for its structural presumptions.²²³

The Canadian efficiency defense provides no limits to the level of concentration that can be authorized thereunder. Without such limits, the acceptance of a valid efficiency defense theoretically may permit the creation of a monopoly or near monopoly that eliminates competition altogether, increases prices for consumers, and effectively obviates or

218. A. NEIL CAMPBELL, *MERGER LAW AND PRACTICE: THE REGULATION OF MERGERS UNDER THE COMPETITION ACT* 156 (1997) (footnotes omitted).

219. Pitofsky Remarks, *supra* note 78.

220. *Id.* at 218.

221. *See, e.g.*, U.S. Merger Guidelines and U.S. 1997 Revisions, *supra* note 75, at ch. 4.

222. *See* Jonathan B. Baker, *Efficiencies and High Concentration: Heinz Proposes to Acquire Beech-Nut (2001) in The Antitrust Revolution: Economics, Competition and Policy* (John E. Kwoka, Jr. and Lawrence J. White, eds., 4th ed. 2004); *see also* Berry, *supra* note 201, at 526-28; Conrath & Widnell, *supra* note 213, at 688-690.

223. Ilzkovitz & Meiklejohn, *supra* note 6, at 22.

frustrates the other purposes of antitrust legislation. Indeed, the practical effect of the Tribunal's decision in *Superior Propane* was to allow near monopolies in several Canadian markets where great efficiencies will be created, at least arguably in the short run (as opportunities for entry were still available as noted by the Tribunal), notwithstanding the Canadian Commissioner's argument that "no merger to monopoly could ever, by definition, bring about gains in efficiency that offset the effects of the merger on competition."²²⁴

We submit that, rather than using postmerger concentrations as an absolute test, the focus of M&A analysis should be on a combination of qualitative and quantitative factors. The imposition of a strict "monopoly" exception would eliminate this. Moreover, where would such a "monopoly" exception kick in—at eighty-five percent, eighty-eight percent, ninety-three percent, or one hundred percent? The result would be rather arbitrary and suggest a precision that is not realistic, particularly where there may be questions as to proper product or geographic market definitions.

Would it therefore be better to discard the presumption based on concentration in favor of a case-by-case adjudication of other factors such as market conditions and net efficiencies? There is, after all, an efficiency in decision making by establishing a rule that is readily administrable rather than, in each case, undertaking a full-blown review of the competitive effects (including efficiencies) likely to occur as a result of the merger.²²⁵ But how valid is the concentration presumption in the first place? The presumption that a transaction will likely result in a price increase based on the concentration levels uniformly set across all industries is viewed by some scholars as weak, absent extraordinary circumstances of creation or enhancement of unilateral market power. In other words, the empirical basis of existing theories for attacking mergers on concentration and market share grounds alone simply lacks a firm foundation. This is particularly believed to be true in markets where technological development is rapid. For instance, under Canadian competition law, market concentration or market share is only one of the factors considered in a merger review. In fact, the Canadian Competition Act provides that the

224. Konrad von Finckenstein, Address at Canadian Bar Association Competition Law Section Annual Meeting, Ottawa (Sept. 30, 1999), available at <http://cb-bc.gc.ca/epic/internet/incb-bc.nsf/vwGeneratedInterE/ct01616e.html>.

225. C. Frederick Beckner III & Steven C. Salop, *Decision Theory and Antitrust Rules*, 67 ANTITRUST L.J. 41 (1999).

Tribunal shall not find that a merger substantially lessens competition solely on the basis of market share or concentration.²²⁶

We submit that, instead of strict conformity with concentration presumptions, a better analytical approach would be to adopt, as part of the merger review, the procedures applied by the U.S. courts in a Sherman Section 1 claim. If the market were very concentrated, a “quick look” approach could be adopted.²²⁷ Under this approach, once the plaintiff or government authority established a prima facie case of illegality (based on market shares, entry barriers, prior conduct, etc.), the burden then would shift to the defendants to produce evidence supporting an efficiency claim. Rarely would it be the case in the merger context that the rule of reason could be applied and dismissed “in the twinkling of an eye.”²²⁸ So long as the defendants were able to show some evidence of legitimate efficiencies claims, a full-blown rule-of-reason analysis would be undertaken to determine the relevant market’s competitive dynamics and the likely competitive effects if the efficiencies were to occur. At the rule-of-reason stage, no presumptions of illegality would be asserted on the basis of concentration; rather, a balancing of the likelihood of anticompetitive effects against the potential for efficiency gains would be employed. The standard of proof should be based on the balance of probabilities for both sides of the balancing process.

VI. CONCLUSION

The role of efficiencies in merger review is still evolving, with the current environment in at least the European Union, and to some extent the United States, still more hostile than would appear to be optimal. In Canada, a more amicable view toward efficiency exists, but there remains considerable controversy regarding how to achieve the right balance and even if the efficiency defense will be maintained in its current form. In the following discussion, we attempt to summarize some of the outstanding issues, as well as possible avenues for reform.

First, some of the common issues associated with estimating reliably the cost savings and other benefits resulting from a merger may be exacerbated when the merging parties operate in a more complex network environment such as telecommunications. For example, network efficiencies must be carefully balanced against the potential for near-

226. The Competition Act, R.S.C., ch. C-34, § 92(2) (1985) (Can.).

227. See *NCAA v. Bd. of Regents*, 468 U.S. 85 (1984); See also *Cal. Dental Ass’n v. FTC*, 526 U.S. 756 (1999).

228. *NCAA v. Bd. of Regents*, 468 U.S. at 109-10, n.39 (quoting PETER AREEDA, THE “RULE OF REASON” IN ANTITRUST ANALYSIS 37-38 (1981)).

dominant networks to tip the market in their favor. Further economies of scale and scope in the telecommunications industry differ from those which are clearly understood in traditional manufacturing industries.

Second, the regulatory filter, deployed by competition authorities, regarding which efficiencies should count, may be unduly fine and limiting, especially when considering some of the complex and unique efficiencies generated in telecom M&A. While productive efficiencies are likely to be recognized, other categories of efficiencies are likely to be viewed with more skepticism or rejected outright. Dynamic or R&D efficiencies can be paramount in telecommunications M&A, yet some competition authorities find them too difficult to predict, quantify, and verify, and therefore discount or reject them. Efficiencies from distribution and promotion, as well as efficiencies from transactional, procurement, and capital cost savings may be given less weight or be rejected, notwithstanding the fact that transactions are designed and entered into on the expectation that such efficiencies will be attained, and in many transactions, they are actually realized. There is a clear need for greater receptivity and understanding by competition authorities of all efficiencies and their underlying rationale (as well as the expected benefits to consumers, whether short or long term), combined with review on a case-by-case basis of the likelihood of achieving such efficiencies.

Third, what standard should be applied in determining whether, on balance, the efficiencies will justify the transaction? Currently, in the United States and European Union, the entire analysis is colored by the consumer surplus standard under which postmerger prices must fall or a direct benefit must flow through to consumers. While a total surplus approach finds considerable support among a number of economic experts, a balancing weights approach may be a reasonable compromise solution that balances the interests of both consumers and suppliers and permits competition authorities to take a more global and protracted view towards efficiencies that would, over the long term, benefit society as a whole. However, effort should be made to reduce the subjectivity and increase the predictability of this method.

Finally, in our view, it would be a mistake for each jurisdiction to proceed in a vacuum in developing divergent efficiency policies. It is essential to the continued evolution of the global marketplace that efficiencies be promoted and reviewed uniformly by competition authorities and the FCC, and that efficiency policies be consistent across jurisdictions. The adoption and evolution of a broader and more universally consistent efficiency defense will increasingly require antitrust authorities to develop an expertise in calculating efficiencies and their effects,

including determining what efficiencies should be included in a tradeoff against postmerger anticompetitive effects, establishing how such efficiencies should be quantified and deciding how they should be weighed against the perceived loss to consumer surplus once they are quantified. Evidence to support the foregoing analyses is sometimes readily ascertainable but may also be varied and not necessarily attainable with ease. However, these analyses can be performed with the benefit of proper accounting and economic expertise. Competition authorities therefore need not shy away from such issues because of complexity or perceived uncertainty.

The challenge is even greater in the context of transborder merger cases, which is increasingly the situation in the global telecommunications industry. With practice and development of the appropriate expertise,²²⁹ these and other challenges arising from the consideration of efficiencies should become more manageable. The analytical work relating to efficiencies must continue if we are to see M&A reviews conducted in a balanced and sensible manner that does not incorrectly impose political values in order to block potentially beneficial transactions out of an abundance of caution nor permit transactions to proceed that result in rampant and prolonged monopoly rent seeking by the merged firm. Such judgments require an enlightened and unbiased careful examination of the entire record rather than reactions premised upon faulty or unsupported political or economic assumptions. It is only through a continued dialogue among competition authorities, economists, lawyers, and business executives that a more appropriate role for efficiencies can emerge in our increasingly global M&A environment.

229. *Scherer Case Western Article*, *supra* note 193, at 22 (“To do the job right, . . . [the agencies] will have to seek new kinds of expertise—e.g., the kind possessed by high-priced management consulting firms.”).

Appendix A
Partial List of Telecom/Media Mergers 1996-2003

<i>Date</i>	<i>Companies</i>	<i>Primary Jurisdiction</i>	<i>Amount US\$B</i>	<i>Antitrust Review</i> ²³⁰
2003	Hughes Electronic Corp.— New Corp. Ltd.	US	6.6	In progress
2002	Granada plc—Carlton Communications plc	Europe (UK)	2	In progress
2002	EchoStar—Direct TV	US	25	F
2002	Rainbow Media Group— Cablevision Systems Corp.	US	1	C
2002	Univision—Hispanic Broadcasting Corp.	US	34	C
2002	Sonera Oyj—Telia AB	Europe	9	C
2001	Global Crossing – Citizens	US	3.5	C
2001	Comcast - AT&T Broadband	US	72	C
2001	BCE Inc. - CTV	Canada	1.7	C
2000	Deutsche Telekom - VoiceStream	US/Europe	53	C
2000	Vivendi - Seagram	US/Europe/ Can	40	C
2000	Telefonica - KPN	Europe	N/A	F
2000	France Telecom - Orange	Europe	46	C
2000	AOL - Time Warner	US	160	C
2000	TELUS - Clearnet	Canada	4.4	C
1999	Vodafone - Mannesmann	Europe	180	C
1999	Mannesmann - Orange	Europe	34	C
1999	Telia - Telenor	Europe	47	F
1999	MCI Worldcom - Sprint	US	129	F
1999	Vodafone AirTouch - Bell Atlantic GTE	US	70	C
1999	Viacom - CBS	US	35	C
1999	Qwest - US West	US	35	C
1999	Olivetti -Telecom Italia	Europe	33	C
1999	Vodafone - AirTouch	US/Europe	74.7	C
1999	AT&T- MediaOne	US	56	C

230. C: merger cleared, F: merger forbidden.

<i>Date</i>	<i>Companies</i>	<i>Primary Jurisdiction</i>	<i>Amount US\$B</i>	<i>Antitrust Review</i> ²³⁰
1998	Call-Net - Fonorola	Canada	1.2	C
1998	Bell Atlantic - GTE	US	52.8	C
1998	AT&T - TCI	US	48.3	C
1998	SBC - Ameritech	US	62	C
1998	Alltel - Aliant	US	1.5	C
1998	AT&T - IBM's Global Network Operations	US/Europe	5	C
1998	AOL - Netscape	US	4	C
1998	Teleglobe Excel Communications	Canada	7	C
1998	AT&T - Vanguard Cellular	US	1.7	C
1998	Northern Telecom - Bay Networks	US	9	C
1998	SBC - SNET	US	4.4	C
1998	Alltel - 360 Degrees	US	6	C
1997	WorldCom - MCI	US	40	C
1996	Bell Atlantic - Nynex	US	25.6	C

Source: Le Blanc & Shelanski, *supra* note 1, in part.

Appendix B
Telecommunications Companies Experiencing Bankruptcy or
Other Financial Difficulties

<i>Company</i>	<i>Sector</i>
UNITED STATES	
Adelphia Communications Global Crossing	CLEC and Cable Company
Covad Communications	CLEC and Cable Company
McLeodUSA	CLEC and Cable Company
NorthPoint	CLEC and Cable Company
Rhythms NetConnections	CLEC and Cable Company
Adelphia Business Solutions	CLEC/DLEC and Cable Providers
Broadband Office	CLEC/DLEC and Cable Providers
Covard Communications	CLEC/DLEC and Cable Providers
CTC Communications	CLEC/DLEC and Cable Providers
e.spire	CLEC/DLEC and Cable Providers
FastComm	CLEC/DLEC and Cable Providers
ICG Communications	CLEC/DLEC and Cable Providers
ITC DeltaCom	CLEC/DLEC and Cable Providers
Knology	CLEC/DLEC and Cable Providers
Metromedia Fiber Network	CLEC/DLEC and Cable Providers
Mpower	CLEC/DLEC and Cable Providers
Network Plus	CLEC/DLEC and Cable Providers
OnSite Access	CLEC/DLEC and Cable Providers
YIPES Communications	CLEC/DLEC and Cable Providers
Zephion	CLEC/DLEC and Cable Providers
Ardent Communications	ISP
colo.com	ISP
Excite@Home	ISP
Exodus	ISP
IBeam	ISP
NetRail	ISP
PSINet	ISP
360networks	Long-haul and Fiber Network Wholesaler
Aleron	Long-haul and Fiber Network Wholesaler
Cambrian Communications	Long-haul and Fiber Network Wholesaler

<i>Company</i>	<i>Sector</i>
Digital Teleport	Long-haul and Fiber Network Wholesaler
Enron Broadband	Long-haul and Fiber Network Wholesaler
GST	Long-haul and Fiber Network Wholesaler
Iaxis	Long-haul and Fiber Network Wholesaler
KPNQwest	Long-haul and Fiber Network Wholesaler
Neon Communications	Long-haul and Fiber Network Wholesaler
Sigma Networks	Long-haul and Fiber Network Wholesaler
Sphera	Long-haul and Fiber Network Wholesaler
Telergy	Long-haul and Fiber Network Wholesaler
Velocita	Long-haul and Fiber Network Wholesaler
Viatel	Long-haul and Fiber Network Wholesaler
Williams Communications Global Crossing	Long-haul and Fiber Network Wholesaler
WorldCom	Long-haul and Fiber Network Wholesaler
WINfirst	Long-haul and Fiber Network Wholesaler & CLEC/DLEC and Cable Providers
Advanced Radio Telecom	Wireless/Satellite Provider
Globalstar	Wireless/Satellite Provider
Iridium	Wireless/Satellite Provider
Metricom/Ricochet	Wireless/Satellite Provider
Motient	Wireless/Satellite Provider
Nextwave Telecom	Wireless/Satellite Provider
OmniSky	Wireless/Satellite Provider
StarBand	Wireless/Satellite Provider
Teligent	Wireless/Satellite Provider
WinStar	Wireless/Satellite Provider
EUROPE	
Deutsche Telekom AG	International and Local Carrier
NTL	CLEC/DLEC and Cable Providers
Song Networks	CLEC/DLEC and Cable Providers
Carrier 1	Long-haul and Fiber Network Wholesaler
Ebone/GTS	Long-haul and Fiber Network Wholesaler
FLAG Telecom	Long-haul and Fiber Network Wholesaler
Pangea	Long-haul and Fiber Network Wholesaler
Storm Telecommunications	Long-haul and Fiber Network Wholesaler

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<i>Company</i>	<i>Sector</i>
Viatel	Long-haul and Fiber Network Wholesaler
CANADA	
AT&T Canada	Long Distance Provider
Microcell	PCS Wireless Provider
Sprint Canada	Long Distance Provider
Teleglobe	International Carrier
GT Group Telecom	Carrier
Axxent	CLEC
Optel	CLEC
LATIN AMERICA	
Impsat	Long-haul and Fiber Network Wholesaler
XO Communications	CLEC/DLEC and Cable Providers
INDIA	
Convergent Communications	CLEC/DLEC and Cable Companies

Appendix C
Comparison of the Treatment of Efficiencies

<i>UNITED STATES</i>	<i>EU</i>	<i>CANADA</i>
No separate statutory efficiency defense; Efficiency gains considered as part of total assessment	Still some debate whether there is an efficiencies defense or offense	Statutory efficiency defense
Efficiency gains must show that transaction is not likely to be anticompetitive	Efficiency gains not yet explicitly recognized as a basis to permit an otherwise anticompetitive transaction	Efficiency gains must be “greater than and offset” anticompetitive effects
Efficiency gains in one market may be weighed against anticompetitive effects in another market as a matter of prosecutorial discretion	No explicit precedent permitting offset	Efficiency gains must be greater than and offset the aggregate anticompetitive effects
Efficiencies must be merger-specific	Efficiencies must be merger-specific	Efficiencies must be merger-specific
Efficiency is a goal of U.S. antitrust law; however, the ultimate goal is consumer welfare	“Technical and economic progress” among principles listed in the Treaty and ECMR	Efficiencies are paramount in Canadian competition policy
Consumer surplus standard or modified price standard or price standard	Consumer surplus standard	Balancing weights approach
Efficiencies almost never justify a merger to monopoly or near-monopoly “Extraordinary” efficiencies required where there are high market concentration levels	Efficiencies unlikely to trump the creation or strengthening of a dominant position	Efficiencies may trump a merger to monopoly or near-monopoly

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<i>UNITED STATES</i>	<i>EU</i>	<i>CANADA</i>
Uncertain whether efficiencies should be passed on in lower prices to consumers D.C. Circuit Court was silent on what are “extraordinary” efficiencies	Must be to the benefit of consumers	No clear methodology for how loss to consumer surplus should be balanced against gains to sellers/shareholders

