Prepared Statement of The Federal Trade Commission

Presented by Robert Pitofsky
Chairman

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Committee on the Judiciary
Subcommittee on Antitrust, Business Rights, and Competition
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I. Introduction

Mr. Chairman and members of the Subcommittee, I am pleased to appear before you today to present the testimony of the Federal Trade Commission concerning the important topic of mergers and acquisitions in the defense industry.[(1)] The testimony addresses the environment facing the defense industry after the Cold War, the policy implications of applying the antitrust laws to defense industry mergers, and the process by which that application takes place.

This testimony will discuss what the Commission believes to be the proper role of antitrust law enforcement in the ongoing consolidation among companies that supply goods and services to the Defense Department. It will also cover the process by which the Commission identifies, investigates, and analyzes mergers[(2)] in order to make a determination whether it has reason to believe a particular merger will harm competition, with particular emphasis on the analysis articulated in the Merger Guidelines jointly issued by the Commission and the Department of Justice,[(3)] and also the role of the Defense Department in the merger review process.

II. Conditions Underlying Consolidation in the Defense Industry

The end of the Cold War ushered in an era of declining defense budgets and sharply reduced expenditures for military procurement, which forced deep cuts in the number and size of weapons programs. In fact, the overall U.S. defense budget has decreased from a peak of $390 billion in 1985 (in constant fiscal year 1997 dollars) to $252 billion in 1997 -- a reduction of about 35%.[(4)] More important from the defense contractors' perspective, however, the procurement budget has incurred the brunt of these cuts, sinking from about $125 billion (fiscal year 1997 dollars) in 1985 to about $44 billion in 1997, a 65% reduction.[(5)] A decline in demand of this magnitude, which occurred in an industry that had invested heavily in plants and infrastructure in the early 1980's based on expectations of continued growth in the demand for weapons and military systems, led quickly to overcapacity among defense contractors.[(6)] This overcapacity, in turn, contributed to excess overhead and higher costs for U.S. military programs.[(7)] The defense industry responded by reducing capacity through consolidation, which has resulted in a significant decline in the number of defense contractors.

Defense Department officials have encouraged consolidation within the industry as an inevitable consequence of shrinking procurement budgets. It has been widely reported, for instance, that in 1993 then-Deputy Defense Secretary William Perry urged defense industry executives to combine into a few, large companies to eliminate costly overcapacity.[(8)] In addition, in 1994, then-Deputy Secretary of Defense John Deutch stated in testimony before the House Armed Services Committee that the Defense Department saw consolidation as "inevitable and necessary."[(9)] More recently, Deputy Under Secretary of Defense John Goodman reiterated the Defense Department's support for the consolidation process.[(10)]

III. Competition Policy Concerns in Defense Industry Mergers

The antitrust laws are designed to protect competition and, ultimately, consumers from the exercise of market power. Congress long ago decided that a competitive economy would provide maximum benefits for consumers in the form of lower prices, optimal quality and quantity of goods and services, and greater innovation than an economy based on government control or the accumulation of market power by private interests. Over one hundred years of experience have proved that to be correct. Thus, the Commission views the application of the antitrust laws to defense industry mergers as squarely in the public interest. Effective antitrust review by the Commission and the Department of Justice protects the Defense Department, and ultimately the American taxpayer, from the risk that a firm or group of firms could exercise market power by raising prices or reducing output, quality, service or innovation.

In analyzing a proposed merger, the Commission focuses on one overriding issue: the likelihood that the transaction will harm customers in any relevant market through increased prices; lower product quantity, quality or service levels; or reduced technological innovation. Such negative effects are likely to occur when a merger results in the accumulation of market power sufficient to raise prices or reduce quality, service or innovation. If the Commission has reason to believe that a merger will create or enhance market power or facilitate its exercise, and there are no countervailing considerations, it is authorized to seek an injunction in federal court to block the merger or to fashion a remedy that will eliminate the competitive problem. If anticompetitive effects are not likely, the Commission will not challenge the transaction.

The framework used by the Commission to analyze mergers is set out in the joint Department of Justice and Federal Trade Commission Merger Guidelines. The Guidelines are a flexible tool designed to be used in all kinds of industries. They anticipate that particular industries have structural and behavioral characteristics that distinguish them from other industries, and provide an analytical framework that takes these characteristics into account. The characteristics of the defense industry fit into the framework of the Guidelines' analysis, leading a Defense Science Board Task Force that analyzed the application of the antitrust laws to defense industry mergers to conclude that "current antitrust law and enforcement, including the exercise of prosecutorial discretion by the federal antitrust enforcement agencies, is sufficiently flexible to take these important differences into account."[(11)]

The analysis of mergers in the defense industry is challenging because of the special characteristics of the industry. The Defense Department is often the only buyer for the products and services of the merging firms, and its procurement processes are different from those in most industries. The products (e.g., weapons systems) being procured are often complex and heterogeneous systems that are frequently purchased on a winner-take-all basis, making cartel behavior less likely. Finally, national security may be implicated in a defense industry merger.

This final point requires further emphasis. The Commission is sensitive to considerations of national security and in particular that a merger will enable the Defense Department to achieve its national security objectives in a more effective manner. The Commission strongly believes, however, that competition produces the best goods at the lowest prices and is also most conducive to innovation. We believe that there is generally no conflict between antitrust enforcement and national security.

The following testimony will review the analytical framework of the Merger Guidelines and explain how that framework applies to defense industry mergers.

IV. Analytical Framework

a. Market Definition

The first step in analyzing any merger is to determine where the potential anticompetitive effects will be felt. This requires defining both relevant product and geographic markets and assessing the impact of the merger on the structure and behavior of those markets. The Commission may need to look at a number of potential markets in any one merger. For instance, if both merging firms make missiles, aircraft, and submarines, the Commission would look at all three of those weapons systems to see if they qualify as relevant product markets. Intermediate products also can constitute relevant markets. Components (such as electronic systems), supplies (such as ammunition), or services (such as systems engineering and technical services) can also be relevant markets.

A relevant product market is one in which many consumers of the product would not switch to an alternative product if the price of the first product were increased by a small but significant amount. In this scenario, a monopolist producer of the relevant product would be said to possess market power because it would have the ability to raise prices profitably without fear of losing business to other products. Once one or more product markets have been defined, we know where to look for the potential exercise of market power by the post-acquisition firm.

In the defense industry, relevant product markets may consist of an existing product, such as tank ammunition, or of the development effort for a future weapon system, such as the design and development of the next generation of tactical aircraft. The "missions" for which the weapons systems are designed will often establish the parameters of the relevant market. For instance, tactical and strategic missile systems are unlikely to be substitutes for one another and therefore are unlikely to be in the same relevant market.

In determining the weapon systems that effectively compete with each other, the Commission collects information from a variety of sources. The records of the merging companies provide substantial information, including detailed descriptions of their respective products and the kinds of products that the companies consider to be alternatives.[(12)] The Commission also interviews other industry participants, such as competitors and potential competitors, as well as suppliers to the companies. We also obtain information from the customers of the merging parties. In the defense industry, this always includes the Defense Department, which has substantial information on the products the companies produce and the technical capabilities of each as well as alternative products. For example, if the potential relevant product market is the research effort to design a new weapon system, the Defense Department, as sole purchaser of that effort, is likely to have information that will enable the Commission to identify the firms capable of participating in that market.

Identifying a relevant geographic market requires a similar analysis. The Commission attempts to identify alternative suppliers in other geographic areas to which customers could turn if prices rose in the relevant product market. In the defense industry, the relevant geographic market almost always encompasses the entire United States. The inquiry typically is whether foreign firms should also be included. In certain instances, the Defense Department limits bidders for contracts to U. S. firms. In other instances, no foreign firms may be capable of producing or designing the product. For those cases, the relevant geographic market is limited to the United States.

Once the relevant markets have been determined, the Commission must identify the participants and their market shares. Market participants include firms that currently sell in the market and firms that could enter relatively quickly and easily. The same sources of information that the Commission uses to define the relevant markets can also be used to identify the actual and potential participants.

A market that is divided evenly among many participants will rarely be susceptible to abuse of market power. Conversely, in a market with only a few participants, the elimination of one of them through merger may substantially increase the risk of anticompetitive effects. The analysis requires more than a simple counting procedure. In rapidly changing industries, such as the defense industry, historical market share statistics may provide an incomplete or inaccurate picture of competitive conditions. Because of declining demand, the nature of the procurement process, and the technological complexity of many new weapons systems, the analysis of current market indices in the defense industry must be supplemented by a forward-looking analysis of the relative cost structures and technological capabilities of the market participants. For any number of reasons, historically strong performers may not be effective competitors in the future. Conversely, a small company that in the past was not a competitive factor may possess new technology that will enable it to capture major contracts in the future.

b. Conditions of Entry

Once the Commission has defined the relevant market and its participants, it must assess the conditions of entry into that market. If entry is easy, post-merger market participants likely will be unable profitably to increase prices above the pre-merger level. According to the Merger Guidelines, entry is regarded as easy if it would be "timely, likely and sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern."[(13)]

In terms of timeliness, the Commission generally uses a two year period. If entry takes longer than that, current market participants may not be deterred from raising prices in the interim. In addition, entry that may occur in the distant future is more uncertain and may not occur at all. In the defense industry, however, the entry period may be shortened or lengthened depending on scheduled procurements. For instance, if the merging parties competed to build fighter aircraft and the next major fighter procurement was scheduled to take place in six months, potential entrants would probably be limited to those companies planning or able to bid in six months' time. The likelihood of entry depends on whether the potential entrant would find it profitable to enter after the acquisition. Sufficiency of entry is determined by the ability of new entrants to force a roll back of prices that may have increased after the acquisition.

Entry analysis in the defense industry may be different in one respect from that applied in other industries. The Defense Department has sometimes provided financial or other assistance to encourage entry by private firms. At other times, the Department has entered into the supply of defense-related products or services on its own. Thus, the Department may be uniquely positioned to provide information about entry conditions and potential participants. This information will be considered with that more routinely collected from the merging parties and knowledgeable third parties in order to make the proper determination of the probability of timely, likely and sufficient entry.

c. Competitive Effects

Once the Commission has collected the necessary information on the relevant markets and entry conditions, it must decide whether it has reason to believe that the merger is likely to have anticompetitive effects. That question is likely to be answered in the affirmative if the merger allows the merging firms or post-merger participants in the relevant market to exercise market power. Market power can be exercised by a price increase or can affect non-price aspects of competition, such as product quality, innovation, service and timely and efficient performance of contractual obligations. In the defense industry, these non-price indicators may be as important as, or even more important than, price.

Merger analysis focuses primarily on the potential of the post-merger firms to lessen competition through unilateral competitive effects or coordinated interaction, either tacitly or through overt collusion. In the defense industry, unilateral anticompetitive effects may be more likely than coordinated interaction.[(14)] Unilateral effects can occur if the merging firms can raise prices without the cooperation of other industry participants. The majority of recent merger challenges in the defense industry have been based on a unilateral anticompetitive effects theory. Two scenarios of competitive harm are typical in the defense industry: where the merging parties are the only capable bidders for an upcoming procurement[(15)] and where the merging parties are the best two potential bidders in terms of cost, technology, or other competitively significant factors.[(16)]

d. Efficiencies

The determination that a merger may have anticompetitive effects typically does not end the Commission's inquiry. The primary benefit of mergers to the economy is their potential to create economic efficiencies that can increase competition and lead to lower costs, lower prices and increased quality to customers.[(17)] The smaller the potential for anticompetitive effects, the greater a role potential efficiencies will play in the Commission's analysis of a transaction. Some of the efficiencies we might recognize include economies of scale, integration of production facilities, enhanced research and development capability, plant specialization and lower transportation costs. Not every efficiency that will lower costs to the merging parties is a cognizable antitrust efficiency. The Commission will consider only efficiencies that benefit consumers. Thus, the parties must show that potential efficiencies will be greater than the likely anticompetitive effects of the merger, are unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects, and are likely to occur. The Commission's experience is that efficiency claims rarely justify mergers to monopoly or near monopoly.

The requirement that efficiencies are likely to occur is difficult to fulfill. Efficiencies are easy to claim but the likelihood of such efficiencies is difficult to demonstrate. Most of the information on efficiencies will be in the hands of the merging parties, who may make broad estimates of cost savings. Nevertheless, the Commission is experienced in analyzing efficiency claims and has developed a number of methods of verifying such claims. The Commission typically contacts other participants in the market who have achieved, or attempted to achieve, efficiencies through similar transactions. We also seek information from firms that have tried to achieve similar efficiencies through less anticompetitive means, such as joint ventures or temporary teaming arrangements. Customers, such as the Defense Department, are also good sources of information regarding potential efficiencies because of their experience as purchasers from the merging firms and in the industry generally.

e. Vertical Mergers

The discussion so far has focused on horizontal mergers between direct competitors. Anticompetitive effects may also occur through vertical mergers that combine a customer and a supplier. The framework for analysis of vertical mergers is similar to that of horizontal mergers with some additional analysis of the unique competitive effects that may be present in a vertical merger. Such a merger is examined to determine, among other things, whether the transaction is likely to raise barriers to entry to potential competitors, foreclose rivals from access to critical components, or create the potential for anticompetitive exchanges of information.

Analytical differences in horizontal and vertical mergers can be seen most easily in the types of remedies the Commission typically imposes in such cases. Horizontal mergers can often be cured of their anticompetitive potential by divestiture of certain assets that would leave the remaining post-merger firm unable to exercise unjustified market power. In vertical mergers, including a number of recent defense industry mergers, the Commission has imposed conduct remedies sufficient to eliminate potential anticompetitive effects. For instance, where vertical mergers create a concern over the transfer of competitively sensitive information, "firewalls" have been imposed to prevent the exchange of a competitor's proprietary information within the different divisions of the combined firm.

V. Commission Investigations of Defense Mergers

The antitrust enforcement agencies review mergers and acquisitions involving defense firms to analyze whether any transaction is likely to diminish price or technology competition for any military program. The Commission has not hesitated to challenge proposed mergers that unduly threaten the Defense Department's ability to obtain the best mix of price and quality for its military requirements. If the Commission believes that a proposed merger is likely to be anticompetitive, it may proceed in one of two ways: (1) the Commission may authorize its staff to seek a preliminary injunction in federal court to block the merger pending final appeal of an administrative complaint; or (2) the Commission and the parties to the transaction may enter into a consent agreement designed to remedy the anticompetitive aspects of the merger.

The Commission in recent years obtained preliminary injunctions in district court against two defense industry mergers, Alliant Techsystems[(18)] and Imo Industries.[(19)] Both of those transactions were ultimately abandoned. More recently, the Commission investigated defense industry mergers that it had reason to believe were anticompetitive as presented, but we negotiated effective remedies that protected the Defense Department and taxpayers without blocking the entire transaction. These mergers include Lockheed's merger with Martin Marietta (1995), Hughes Aircraft's acquisition of Itek's Optical Systems Division (1996), Litton Industries' acquisition of PRC (1996), Raytheon Company's acquisition of Chrysler Technologies Holding, Inc. (1996), Lockheed Martin's acquisition of Loral (1996), and Boeing's acquisition of Rockwell's aerospace and defense businesses (1996).

Lockheed's merger with Martin Marietta is an example of a defense merger in which we entered into a consent agreement to resolve a significant anticompetitive problem. This merger raised substantial antitrust concerns in the market for Space-Based InfraRed Early Warning (SBIR) Satellite Systems, a $22 billion satellite system that uses highly sophisticated electro-optical sensors to detect hostile missile launches against the United

States or its allies. Lockheed and Martin Marietta were competing as prime contractors for the SBIR contract and had entered into exclusive teaming agreements with the top two sensor providers, Hughes and Northrop Grumman, respectively. Because the merger would have combined the top two SBIR teams, the Lockheed team and the Martin Marietta team, the combined Lockheed Martin would have been in a position to raise price or decrease quality unilaterally on one or both teams without fear of losing the SBIR competition. The Commission's consent order remedied the merger's anticompetitive effects by prohibiting Lockheed and Martin Marietta from enforcing their exclusive teaming agreements with Hughes and Northrop Grumman for the critical sensor components in the SBIR systems. This allowed Lockheed Martin to continue working with those teammates, but also freed Hughes and Northrop Grumman to team with additional satellite companies. As a result of the Commission's order, additional teams were formed to compete against Lockheed Martin for the Defense Department's SBIR contract.

The Commission recently announced its decision not to challenge Boeing's acquisition of McDonnell Douglas, following one of the most detailed and wide-ranging investigations in the history of merger enforcement.[(20)] A large team of Commission attorneys, economists and accountants gathered a tremendous volume of evidence on the acquisition's potential effects on competition in the worldwide commercial aircraft industry and in military programs. On the commercial side, the Commission staff interviewed over forty airlines (including almost every U.S. carrier, large and small, and many foreign carriers), as well as other industry participants, such as regional aircraft producers and foreign aerospace companies. Staff deposed McDonnell Douglas and Boeing officials responsible for marketing commercial aircraft, assessing their firms' financial conditions, and negotiating the proposed acquisition. The Commission staff also reviewed hundreds of boxes of documents submitted by the merging companies and third parties, such as airlines and aircraft manufacturers. A majority of the Commission concluded that the acquisition would not substantially lessen competition or tend to create a monopoly in the global commercial aircraft market.

On the military side, the Commission assessed the acquisition's likely impact on future prices and technology innovation for Defense Department programs where Boeing and McDonnell Douglas would be expected to compete. After receiving a significant volume of information from Boeing and McDonnell Douglas, other industry participants, and Defense Department officials, the Commission found that Boeing and McDonnell Douglas currently develop fighter aircraft and military helicopters for different missions, and there are no anticipated Defense Department procurements of fighter aircraft or military helicopters or other domestic military markets in which the two firms would likely compete.

VI. Conclusion

The defense industry is undergoing a period of significant consolidation, spurred in part by significant reductions in defense procurement budgets. Policy makers, however, cannot acquiesce in anticompetitive mergers. Consolidation can occur in ways that protect the major buyer of weapons systems from the creation of market power in its supplier base.

The Defense Science Board Task Force concluded that "as a matter of law, as well as expertise and experience, the antitrust agencies bear responsibility for determining the likely effects of a defense industry merger on the performance and dynamics of a particular market and whether a proposed merger should be challenged on the grounds that it may violate the antitrust laws."[(21)]

The Defense Department has had, and will continue to have, a major role in cooperating with the antitrust agencies in their analysis of the competitive implications of defense industry mergers. The Defense Department has a vast and unique array of information that is important to antitrust analysis. Over the past few years, the Defense Department has been able to assemble and convey this information to the antitrust agencies in a timely manner. Because the Defense Department is the major customer of defense industry firms, its views on the likely impact of a transaction are given great weight. Nevertheless, the final decision whether to challenge a proposed defense industry merger remains--as it must--with the antitrust enforcement agencies.

Antitrust policy, including the policy of challenging consolidations that create or increase the potential for abuse of market power, is designed to apply to all industries. By promoting a competitive economy, the antitrust laws ensure that consumers will receive the best quality goods and services at the lowest prices. As the major consumer of defense industry products, the Defense Department seeks the same goals. Vigorous enforcement of the antitrust laws is thus entirely consistent with the goal of preserving a strong national defense.

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1. This written statement represents the views of the Federal Trade Commission. My oral presentation and response to questions are my own, and do not necessarily represent the views of the Commission or any other Commissioner.

2. The federal antitrust laws that apply to mergers include section 5 of the Federal Trade Commission Act, section 7 of the Clayton Act, and section 1 of the Sherman Act. The Commission has enforcement authority under section 5 of the FTC Act and section 7 of the Clayton Act. Each of these statutes applies to mergers, acquisitions and cash tender offers. The term "mergers" is a shorthand for all of these types of consolidations unless the text indicates otherwise.

3. U. S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, 4 Trade Reg. Rep. (CCH) ¶ 13,104 (April 2, 1992), *as amended*, April 8, 1997.

4. Statement of John B. Goodman, Deputy Under Secretary of Defense (Industrial Affairs and Installations), Before the Subcommittee on Acquisition and Technology of the Senate Committee on Armed Services, at 2 (April 15, 1997).

5. Id.

6. Office of the Under Secretary of Defense for Acquisition & Technology, Report of the Defense Science Board Task Force on Antitrust Aspects of Defense Industry Consolidation, at 8 (April 1994) ("Task Force Report").

7. Though excess capacity drives competitive prices down in most industries, it causes prices to increase for many military programs because contract prices for many weapons systems are based on costs. With excess capacity and declining demand, overhead costs are assigned to ever shrinking volumes, with the result that each unit of hardware gets more expensive. (Task Force Report at 8)

8. "How a Dinner Led to a Feeding Frenzy," Washington Post, July 4, 1997, at G1.

9. Defense Industry Mergers, Hearing of the Oversight and Investigation Subcommittee of the House Armed Services Committee, Statement of John Deutch (Fed. News Service, July 27, 1994).

10. Statement of John B. Goodman, Deputy Under Secretary of Defense (Industrial Affairs and Installations), before the Subcommittee on Acquisition and Technology of the Senate Committee on Armed Services, at 3 (April 15, 1997).

11. Task Force Report at 15. The Task Force was composed of defense and antitrust experts, government enforcement officials and consumer representatives, and was charged by the Under Secretary of Defense to "provide advice on how the Department of Defense can play a constructive role in antitrust review by the Department of Justice and the Federal Trade Commission of mergers and joint ventures in the defense industry." Memorandum for Chairman, Defense Science Board from Task Force Chairman Robert Pitofsky, at 1 (March 24, 1994). The Task Force recommended that the Defense Department develop an institutional capacity to collect and transmit information and its views on the competitive consequences of a merger to the antitrust agencies. Id. Since the issuance of the Task Force Report, the Federal Trade Commission and the Antitrust Division of the Department of Justice have received the extensive analysis of the Department of Defense on numerous proposed mergers.

12. Pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a, the parties to mergers that meet specified thresholds are required to file certain information with the antitrust agencies and refrain from consummating the transaction for 30 days (15 days for a cash tender offer). If the information indicates that the merger may have potential anticompetitive effects, the agency reviewing the transaction may request additional information from the parties, extending the waiting period for 20 days (10 days for a cash tender offer) following compliance by the parties with the requests for additional information.

13. Horizontal Merger Guidelines, at § 3.0.

14. That does not mean that coordinated effects are invariably unlikely. For example, in 1994, the Justice Department secured a consent decree in a case where the only two competitors for a competition teamed together to submit a joint bid. United States v. Alliant Techsystems Inc., 1994-1 Trade Cas. (CCH) ¶ 70,595 (C.D. Ill. 1994).

15. See FTC v. Alliant Techsystems Inc., 808 F. Supp. 9 (D.D.C. 1992).

16. See FTC v. Imo Industries Inc., 1992-2 Trade Cas. (CCH) ¶ 69,943 (D.D.C. Nov. 22, 1989)(redacted memorandum opinion).

17. Horizontal Merger Guidelines, at § 4.0.

18. 808 F. Supp. 9 (D.D.C. 1992).

19. 1992-2 Trade Cas. (CCH) ¶ 69,943 (D.D.C. Nov. 22, 1989).

20. Four Commissioners explained their decision not to challenge the merger in a majority statement. See Statement of Chairman Robert Pitofsky and Commissioners Janet D. Steiger, Roscoe B. Starek, III and Christine A. Varney in the Matter of The Boeing Company/McDonnell Douglas Corporation, File No. 971-0051 (July 1, 1997). Commissioner Mary L. Azcuenaga issued a separate statement, disagreeing, in part, with the majority's conclusions. See Statement of Mary L. Azcuenaga, File No. 971-0051 (July 1, 1997).

21. Task Force Report at 38.