Prepared Statement of The Federal Trade Commission

Presented by Robert Pitofsky
Chairman

Before The
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

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. Ir al02 Tc a4(i)-6(d)858kr14(r)-1(o)-4(d)-4(u)-4(ct)-6(s)-5(al)-1 Components (such as electronic systems), supplies (such as ammunition), or services (such as systems engineeng and techn a4(i)-6(c)-10(al)-6(s)-5(er)-1(v a4(i)-6(c)-10(es)-5(

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 p

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

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

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 tra

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

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

6. Office of the Under Secretary of Defense for Acquisition & Technology, Report of the Defense Science Board T

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.