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ROUNDTABLE ON THE ROLE OF EFFICIENCY CLAIMS IN ANTITRUST PROCEEDINGS

-- Note by the Delegation of Japan --

This note is submitted by the delegation of Japan to the Competition Committee FOR DISCUSSION under Item XII at its forthcoming meeting to be held on 24-25 October 2012.

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ROUNDTABLE ON THE ROLE OF EFFICIENCY CLAIMS IN ANTITRUST PROCEEDINGS

-- Note by Japan --

1. Introduction

1. During the course of an investigation, hearing or trial, enterprises often claim that their activities improve efficiency and therefore do not violate the Antimonopoly Act (hereinafter referred to the “AMA”). Although there are no provisions for efficiency, the guidelines regarding merger and private monopolization demonstrate the basic viewpoints on efficiency.

2. We will describe below the basic viewpoints on efficiency stated in the guidelines, and the case examples regarding mergers (Part II) and private monopolization (Part III). In addition, we will introduce the stage where we consider efficiency; the evidence submitted by enterprises and ex-post evaluation of mergers in Part II. Furthermore, we will also introduce the burden of proof of efficiency regarding private monopolization in Part III.

2. Efficiency claim regarding merger[1]

2.1 The basic viewpoints on efficiency stated in the “Guidelines to application of the Antimonopoly Act Concerning Review of Business Combination” (hereinafter referred to as the “Merger Guidelines”)

3. The Japan Fair Trade Commission (hereinafter referred to as the “JFTC”) considers the efficiency of mergers as one of “the factors for judging whether competition would be substantially restrained or not” in the review of horizontal mergers, and states basic viewpoints in the Merger Guidelines as described below. These basic viewpoints will be applied to vertical mergers and conglomerate mergers. In addition, although Merger Guidelines state that unilateral conduct by the company group[2] and coordinated conduct between the company group and its competitors will be distinguished when reviewing whether the merger will restrain competition or not, the aforementioned viewpoints will be applied mutatis mutandis to both types of conduct.

4. When the parties concerned claim efficiency improvement, the JFTC reviews their claim in accordance with such views.

2.1.1 Efficiency

5. When efficiency improvement, whether through economies of scale, integration of production facilities, specialization of factories, reduction in transportation costs or efficiency in research and

1 http://www.jftc.go.jp/en/legislation_guidelines/ama/pdf/110713.2.pdf

2 “Company group” means that all companies that would form, maintain, and strengthen the joint relationships by mergers which are subject to merger review.

development, is deemed likely to make the company group take competitive action after the business combination, this factor will also be considered to determine the impact of the business combination on competition.

6. Efficiencies to be considered in this case are determined from three aspects: (i) efficiencies should be improved as effects specific to the business combination; (ii) efficiency improvement should be feasible; and (iii) efficiency improvement contributes to the users' welfare.

7. Business combinations that create a state of monopoly or quasi-monopoly are hardly ever justified by their efficiency.

- Efficiency Improvement Should Be Specific to the Business Combination

  Efficiency improvement should be specific to the business combination. Therefore, such factors related to the expected efficiency as economies of scale, integration of production facilities, specialization of factories, reduction of transportation costs, or efficiency in research and development such as next-generation technology and environmentally friendly capabilities cannot be achieved by other means that are less restrictive of competition.

- Efficiency Improvement Should Be Feasible

  Efficiency improvement should be feasible. This is analyzed, for example, using documents of internal procedures leading to the decision of the business combination, explanatory materials for shareholders and financial markets regarding the expected efficiency, and studies by external specialists concerning the improvement in efficiency.

- Efficiency Improvement Contributes to the Users' Welfare

  The outcome of efficiency improvement from the business combination must be returned to users through reduced prices of products and services, an improvement in product quality, a supply of new products, or efficiencies in research and development, such as next-generation technology and environmentally friendly capabilities. In this regard, in addition to the materials listed in (ii), these are to be analyzed, for example, as information related to improved capabilities that will bring effects such as a price reduction and the history of actual price reductions, quality improvement and supply of new products being realized through competitive pressure from the demand and supply side.

2.2 Practical issues in claiming efficiency improvement from mergers

8. Merger Guidelines mention efficiency as one of the factors for judging whether competition would be substantially restrained or not. In addition, "Policies Concerning the Procedures for the Review of Business Combinations", which indicates the JFTC's policies in relation to the process of merger review, mentions the following material as examples referred to by the JFTC in merger reviews: descriptions of plans to rationalize and improve efficiency in accordance with mergers and bases for calculating economic effects; documents about the process of internal decision that led to the merger; explanatory material on efficiency for shareholders and financial markets; and material describing track records in price reductions, quality improvements, the amount of new products offered and other matters that were a result of the efficiency improvement.

9. As indicated in section 3 below, when faced with the cases in which the parties concerned asserted that their mergers mainly brought about cost reductions and enhanced users' welfare, the JFTC reviewed them based on the Merger Guidelines.

2.3 Cases in which parties claimed efficiency

2.3.1 Establishment of a joint venture for producing iron ore by BHP Billiton PLC and BHP Billiton Limited and Rio Tinto PLC and Rio Tinto Limited[3]

2.3.1.1 Outline of the case and progress of the review

10. BHP Billiton PLC and BHP Billiton Limited (hereinafter referred to as "BHP Billiton") and Rio Tinto PLC and Rio Tinto Limited (hereinafter referred to as "Rio Tinto"), each engaged in the business of mining and sales of iron ore, etc., and planned to establish a joint venture to produce iron ore in Western Australia (hereinafter referred to as the "JV"). The provision applied to this case is Article 10 of the AMA.

11. In response to a prior consultation on the establishment of a JV with both parties concerned, the JFTC commenced its review. On 27 September 2010, after finishing the primary review and while in the process of the secondary review, the JFTC highlighted its concerns to both parties. Thereafter, the JFTC closed the review concerning prior consultation following the withdrawal of the planned JV, which was publically announced by both parties on 18 October 2010[4].

2.3.1.2 Judgment regarding efficiency

12. In this case, the parties concerned alleged that if they were to establish the JV and integrate iron ore production businesses in West Australia, this integration would allow them to achieve efficiency in excess of 10 billion U.S. dollars. In response to this allegation, the JFTC made a judgment on "lump ore" and "powder ore" which are defined as relevant markets as follows:

- Lump Ore.

  The JFTC assumes that the JV would bring about a situation similar to monopoly, and consequently, achieving efficiency as alleged by the both parties would not cause competitive behavior by both parties. For this reason, the alleged does not justify the JV.

- Powder Ore

  The JFTC scrutinized the potential for efficiency alleged by both parties from the following three viewpoints: (i) whether or not improved efficiency is specific to a proposed business combination (particularity); (ii) whether or not improvements in efficiency are feasible(feasibility); and (iii) whether or not improvements in efficiency contribute to users' welfare (possibility of increasing users' welfare).The results revealed that none of the above viewpoints could be identified due to the following reasons.

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3 http://www.jftc.go.jp/en/pressreleases/%EF%BD%90%EF%BD%84%EF%BD%86110621MajorBusinessCombinationCasesFY2010.pdf

4 The view described in the paragraph b is what expressed by the JFTC at the time when the concerns were pointed out to the parties. Therefore, the following view is not the final judgment by the JFTC in response to the submission of their counter opinion.

- *Particularity.* Although both parties concerned alleged that efficiency is achieved by sharing and integrating infrastructure through establishment of a JV, it is believed that such efficiency can be achieved by alternative measures which do not restrain competition in comparison to the JV.

- *Feasibility and possibility of increasing users' welfare.* The parties concerned not only alleged that an increase in iron ore production and reduction in operational costs would allow them to achieve efficiency in excess of 10 billion U.S. dollars, but also alleged that standardization of iron ore quality through iron ore blending would achieve an increase in users' welfare. However, the feasibility of reducing capital expenditures and operational costs through establishing the JV is not necessarily clear. In addition, even if a reduction in capital expenditures was achieved, such expenditures are basically associated with fixed costs and are thereby not directly profitable for users. Similarly, the JFTC cannot completely identify the feasibility and possibility of increasing users' welfare in other claims made by both parties.

2.3.2 Proposed Business Combination between Tokyo Stock Exchange Group, Inc. and Osaka Securities Exchange Co., Ltd.

2.3.2.1 Outlines of the case

13. Tokyo Stock Exchange Group, Inc., which owns subsidiaries including Tokyo Stock Exchange Inc., is establishing a financial instrument market with a license granted by the Prime Minister under the provisions of the Financial Instruments and Exchange Act. Tokyo Stock Exchange Group, Inc. planned to acquire shares in Osaka Securities Exchange Co., Ltd., which is also establishing a financial instrument market with a license, and to acquire more than half the voting rights (hereinafter referred to as "Business Combination"). The provision applied to this case is Article 10 of the AMA.

2.3.2.2 Judgment regarding efficiency

14. In this case, the parties argued that the Business Combination could improve efficiency given that an annual cost reduction of around seven billion yen is expected in all fields of trade which are subject to review, as a result of the integration of systems following the Business Combination.

15. However, the JFTC judged that it could not take efficiency improvement into consideration, from the following three viewpoints: (i) whether or not improved efficiency is specific to a proposed business combination (particularity); (ii) whether or not improvements in efficiency should be feasible (feasibility); and (iii) whether or not improvements in efficiency contribute to users' welfare (possibility of increasing users' welfare). In this case, the parties concerned had not decided the time frames in which they would integrate the systems and achieve the cost reduction related to the systems. Their explanations about particularity, feasibility and the mechanisms for increasing user's welfare were also insufficient. In addition, as a result of the Business Combination, there would be an extreme increase in the market share of the parties concerned in services related to listing stocks on the emerging markets, which would lead to a state of quasi-monopoly. Consequently, the parties concerned were not expected to take competitive action such as price reduction, even if the improvement of efficiency could materialize as the parties had argued.

16. Therefore, the JFTC decided that efficiency improvement could not be taken into consideration.

2.4 Ex-post analysis of mergers

17. The Competition Policy Research Center (CPRC) of the JFTC has examined the effects of mergers, and published research reports entitled, *Economic Analysis of the Efficiency of Mergers and their Impact on Markets,* in September 2003, and *Ex-post Examination of Business Combinations,* in November 2011.

2.4.1 Economic Analysis of the Efficiency of Mergers and their Impact on Markets (September 2003)

- Focus points in the research

  This research focuses on efficiency brought about by mergers, and seeks to undertake demonstrative analyses of the degree of efficiency achieved through mergers and changes in the post-merger market outcomes.

- Analysis methods

  For each of the major merger cases between enterprises that listed on the stock exchange between 1980 and 1999, the following research analyses were conducted: (1) analysis and study of how efficiency had been achieved, using financial data; (2) price analysis of how market prices were affected by mergers, using an econometric model that attempts to explain price changes based on demand and cost factors; and (3) analysis of how the stock market predicted how efficiency would be achieved and how prices would fluctuate as a result of the merger, applying event study methodology of stock prices.

- Analysis results

  The analysis of financial data revealed that although partial cost reductions were observed in some cases, based on changes in the cost indices and profit ratio indices, there was no case that clearly showed cost reductions.

  The price analysis showed that in some cases, there was a significantly greater rise in post-merger prices than the expected price level that would have been increased if the pre-merger conditions had remained the same. On the other hand, there were cases where the post-merger prices remained the same as the pre-merger prices, and even cases where post-merger prices fell significantly below the expected price level that would have been increased if the pre-merger conditions had remained the same. However, these results may be attributed to factors other than efficiency improvements and the revitalization of competition brought about by the merger.

  In Japan, the crossholding of shares among corporations can be observed to a significant extent. In addition, the actions of institutional investors can affect stock price changes. Therefore, the effectiveness of event study methodology of stock prices, which is based on changes in prices that are brought about by announcements regarding a merger, may be restricted to a certain degree. However, in many of the cases analyzed, a significant and abnormal return was observed in the stock prices of the merging party and competitor companies on the day of the event.

  See DAF/COMP/WD(2007)56 for details of the analysis results.

2.4.2 *Ex-post Examination of Business Combinations (November 2011)*

- Focus points in the research

  In order to verify whether merger cases to date have achieved efficiency, including profitability enhancements, the research empirically verifies the outcomes of mergers since 2000 based on the data on profit ratios, stock prices, research and development costs, number of published patents and product retail prices.

- Analysis methods

  – *Analysis of profit ratio*. The propensity score matching and difference-in-difference method were used together to analyze whether the ROE and other business management indexes showed improvements after the merger.

  – *Stock price analysis*. Event study methodology of stock prices was used to analyze whether stock prices rose after the merger.

  – *Analysis of research and development*. An analysis was carried out to determine whether the ratio of research and development costs to sales and the number of patents increased after the merger.

  – *Analysis of product retail prices*. A regression analysis was conducted using POS data to analyze whether retail prices of products fell after the merger.

- Analysis results

  – *Analysis of profit ratio.* It was confirmed that the merger had no significant effect regarding the profit ratio, and there were rather more cases in which the profit ratio worsened.

  – *Stock price analysis.* The stock price analysis showed a rise in stock prices on the day of the announcement of the merger, and the excess profit ratio moved positively in many cases. However, in most cases, the stock price also fell after a few days and the effects of the cumulative abnormal return ratio are close to zero.

  – *Analysis of research and development.* The analysis of research and development showed a post-merger decline in the accumulation of research and development efforts and the number of patents, in many cases. When it comes to knowledge-intensive enterprises, the research and development costs increased in many cases. However no similar trend was observed regarding the number of patents.

  – *Analysis of product retail prices.* The analysis of product retail prices showed a rising trend in the average post-merger market prices for seasonings and sugar, and the post-merger stock prices of the enterprises showed a further rising trend. In some cases, enterprises adjusted the product retail price to differentiate between the product groups sold by the merging parties.

  See CPDP51-E (2011.7)[5] for details of the analysis results.

[5] "The Impact of Mergers on Profits, Share Value,Innovation, and Product Prices in Japan in the 2000s" http://www.jftc.go.jp/cprc/DP/abstract/CPDP-51-E_abstract.html

3. Efficiency claim regarding private monopolization

3.1 The basic viewpoints on efficiency stated in "The Guidelines for Exclusionary Private Monopolization under the Antimonopoly Act" (hereinafter referred to as "Exclusionary Private Monopolization Guidelines")

18. The JFTC considers the efficiency of private monopolizations as one of the deciding factors regarding "the substantial restraint of competition" of private monopolizations, and states basic viewpoints in the Exclusionary Private Monopolization Guidelines as described below.

19. Where the alleged enterprise is expected to take competitive actions owing to the improvement of productivity, technological innovation, and the improvement of the efficiency of business activities—which are caused by the economies of scale, integration of production facilities, specialization of factories, reduction of transportation costs, and improvement of the efficiency of research and development systems that are incidental to exclusionary conduct of said enterprise, such circumstance may be taken into account to assess whether or not competition is substantially restrained.

20. In such a case, the efficiency improvements will be taken into account when: (i) it is deemed that efficiency improvement is specific to the conduct, and cannot be achieved by other means that are less restrictive of competition, and (ii) it is deemed that outcomes such as a decline in the product prices, an improvement in product quality, and a supply of new products are returned to users due to the improvement of efficiency and users welfare..

21. For example, in some cases of Tying, the economics of scale may work in the tied products, and the demand for the tied products cannot be increased by means other than selling the tied products together with the tying products. In this situation, where the supply of the tied products is deemed to have increased, resulting in the supply of the products to users at the lower price, and the improvement of users' welfare as a result of promoting competition within the market, the JFTC will consider such circumstances to assess whether or not competition is substantially restrained.

22. However, where exclusionary conduct causes monopoly or a monopolistic situation, it would normally be concluded that competition is substantially restrained.

3.2 The burden of proof of efficiency claims regarding private monopolization

23. Efficiency claims are related to whether a substantial restraint of competition can be found or not. When enterprises claim that their activities do not fall under private monopolization and do not violate the AMA because of efficiency improvement, the burden of proof of a substantial restraint of competition will fall on the investigator in hearings and on the JFTC in lawsuits to rescind decisions.

24. In cases where efficiency seems to have been improved to some extent, the investigator or the JFTC has to bear the burden of proof of a substantial restraint of competition in consideration of efficiency. By contrast, the enterprises which are subject to administrative orders would rebut the finding-fact or the JFTC's evaluation regarding efficiency. They would also try to prove the facts that have not been proven by the JFTC. Although distribution of the burden of proof is not ruled clearly in the law provisions, hearing trials or lawsuits usually proceed based principles such as those described above.

3.3 The case in which the offender claimed efficiency (Tokyo High Court decision on NTT East case)

25. When NTT East provided a telecommunication service to the user's residences using optical fiber equipment (hereinafter referred as to the "FTTH service"), it set a lower fee for users than the fee charged

to specific telecommunication enterprises for using optical fiber equipment (They had to use such equipment in order to provide a service similar to the FTTH service.). The JFTC found that NTT East's activity fell under private monopolization (Paragraph 5 of Article 2 of the AMA) and violated Article 3 of the AMA, and they issued a hearing decision against NTT East, on March 26, 2007.

26. Although NTT East filed a suit to rescind the decision described above, the Tokyo High Court made the decision to dismiss this appeal on May 29, 2009. Following the Tokyo High Court's decision, the Supreme Court refused NTT East's final appeal on December 17, 2010; consequently this decision was final and binding.

27. NTT East's claim and the Tokyo High Court's decision are briefly discussed below. It should be noted that the plaintiff's claim involved efficiency improvement with regards to the issue of exclusivity of NTT East's actions. While the Exclusionary Private Monopolization Guidelines consider the efficiency of private monopolizations as one of the deciding factors regarding "the substantial restraint of competition," as previously mentioned, the plaintiff's claim was made prior to the announcement of the guidelines.

3.3.1 Plaintiff's claim regarding efficiency

28. The price reduction of the FTTH services helped to suppress consumer prices and enhance efficiency. As a result, low price setting is a competitive activity, and would only become anti-competitive in rare exceptional cases, such as the continuous provision of services at prices far below the required costs for the services. The activity in this case is a justifiable act of competition that promotes competition in price and quality efficiency, and does not come under the category of exclusive conduct.

3.3.2 Court decision

29. The Tokyo High Court initially confirmed the JFTC's hearing decision, which stated that NTT East's activity had made it difficult for other telecommunications carriers lacking optical fiber equipment to enter the FTTH services market, and consequently excluded them from the market.

30. Subsequently, in response to the plaintiff's claim, the Tokyo High Court stated, "The plaintiff has made it extremely difficult for other telecommunications carriers to enter the FTTH services market, while attempting to gain users. Such an act is inevitably recognized as an anti-competitive activity, which is prohibited in the market of FTTH services for users' residences." In conclusion, the Court denied the plaintiff's claim that its activity is justified because it is competitive and enhances efficiency.

4. Conclusion

4.1 Comparison of efficiency claim between mergers and private monopolizations

31. When the JFTC reviews the efficiency claim in mergers and private monopolizations, it takes both static and dynamic efficiency into account.

32. Merger Guidelines list the following three viewpoints for reviewing efficiency: particularity, feasibility and the possibility of increasing the users' welfare. Exclusionary Private Monopolization Guidelines also state that the "particularity" and "possibility of increasing the users' welfare" is considered when evaluating efficiency. By contrast, since the enforcement against private monopolization is ex-post regulation to the enterprises' activities, "feasibility" will not be considered when evaluating efficiency.

4.2 Cases in which parties or offenders claimed efficiency

33. Parties concerned and offenders have often claimed efficiency improvement, and the JFTC considered efficiency in some recent merger cases.

34. However, all efficiency claims by parties concerned and offenders have been refused by the JFTC or the courts.

35. We consider that such claims will continue to be made in the future.

4.3 Ex-post evaluation of efficiency

36. Although we have never conducted ex-post evaluations of private monopolizations, the CPRC conducted two ex-post evaluations regarding the efficiency of mergers in 2003 and 2011, as described above. These reports concluded that there was no clear link between the mergers and efficiency improvement.

REFERENCE

Hiroyuki Odagiri (2007), "Mergers and Economic Performance: Do Efficiency Gains Justify Horizontal Mergers?" http://www.jftc.go.jp/cprc/DP/CPDP-27-E.pdf