

**Testimony of David A. Balto, Senior Fellow,  
Center for American Progress Action Fund**

**To the Committee on the Judiciary  
United States House of Representatives  
Regarding “Competition in the Package Delivery Industry”**

**Tuesday, September 9, 2008**

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**Introduction**

Mr. Chairman, Ranking Member Smith, and other distinguished members of the House Judiciary Committee, I want to thank you for giving me the opportunity today to speak about the competitive problems that may arise from DHL’s proposed alliance with UPS. As detailed in my testimony, this alliance will raise serious competitive concerns and could potentially lead to significantly higher prices for the millions of consumers and businesses (large and small) that use express package delivery services every day. Thus, the alliance should be thoroughly investigated by the antitrust authorities before it is consummated.

I make the following points in my testimony:

- It is unlikely a UPS/DHL merger would be approved by the agencies or the courts;
- The proposed UPS/DHL arrangement will raise significant competitive concerns and diminish DHL’s ability and incentive to compete;
- DHL’s weakened financial status does not justify the arrangement; and
- The DOJ or FTC should immediately open an investigation and the parties should agree not to consummate that arrangement until the investigation is completed.

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<sup>1</sup> I am also testifying on behalf of the Consumer Federation of America. CFA is the nation’s largest consumer advocacy group, composed of over 280 state and local affiliates representing consumer, senior citizen, low income, labor, farm, public power and cooperative organizations, with more than 50 million individual members.

My testimony today is based on my experience of over a quarter century as an antitrust practitioner, the majority of which was spent as a trial attorney in the Antitrust Division of the Department of Justice, and in several senior management positions, including Policy Director at the Federal Trade Commission (“FTC”). I regularly practice before both the agencies, and frequently represent consumer groups raising concerns about mergers under investigation by the Antitrust Division or the FTC.

I am here with a simple message for this Committee. Although the parties have asserted that “there are no grounds for the [Presidential] candidates’ demands for an antitrust investigation”<sup>2</sup> or “it’s a little surprising that anybody could realistically look at this and argue that it raises antitrust issues,”<sup>3</sup> they are simply wrong. Dressing up this arrangement as a so-called alliance does not diminish its substantial potential anticompetitive effects. Having DHL depend on UPS for its most critical functions will extinguish rivalry and greatly enhance the likelihood of higher prices and weaker service. Millions of consumers will suffer.

This so-called alliance is not subject to the filing requirements of the Hart-Scott-Rodino Act. Thus, the parties can consummate their arrangement the day it is announced, irretrievably changing the market environment and placing thousands of workers out of work. Once the alliance is consummated, the “eggs will be scrambled” and should DOJ or the FTC determine at a later date that the alliance harms competition, it will be almost impossible to restore competition.

I have a simple request for the Committee and the parties. This Committee should request that parties delay consummating their arrangement until the DOJ or the FTC conducts a full investigation of the arrangement. I recommend that the parties agree to permit the agency to conduct a full investigation, similar to a merger “Second Request” investigation before consummating their arrangement. As such the agency should be able to use compulsory process to evaluate the parties’ assertions and competitive effects of the alliance. As in a merger investigation, the arrangement should only be consummated after the federal agency determines that it will not harm competition.

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<sup>2</sup> Dr. Frank Appel, Deutsche Post CEO (WSJ, Aug. 14, 2008). The parties may suggest there are no antitrust concerns because this is simply a supply agreement. They are mistaken. Any arrangement between competitors can be challenged under the Sherman Act including supply agreements.

<sup>3</sup> Norman Black, UPS spokesman (WSJ, Aug. 8, 2008).

## **It is Unlikely that a Merger Between DHL and UPS would be Approved by the Courts or the Agencies**

The facts surrounding the express package delivery service market are straightforward. There are three major competitors: Federal Express, UPS and DHL, which together control over 90% of the market. (The U.S. Postal Service also participates in the market but its market share is small and diminishing). Their respective market shares are: Federal Express 44%, UPS 42%, and DHL 7%. DHL's market share has decreased from about 20% in 2003. Currently DHL has significant excess capacity. There has been no successful entry in the express package delivery service for years, and the number of competitors has decreased significantly.

A merger between DHL and UPS would effectively turn the express package delivery market into a duopoly, with two firms with over a 90% market share. You do not have to be a Ph.D. economist or an antitrust scholar to recognize that a duopoly presents the most fertile environment for collusion. Simply, it is far easier to dance the waltz of collusion when there are only two partners on the dance floor instead of three. *See American Hospital Supply Corp. v. Hospital Products Limited*, 780 F.2d 589, 602 (7th Cir. 1986) (“it is easier for two firms to collude without being detected than for three to do so”). *See also FTC v. Heinz*, 246 F.3d 708, 725 (D.C. Cir. 2001) (“The creation of a durable duopoly afford both the opportunity and incentive for both firms to coordinate to increase prices.”); *United States v. Ivaco*, 704 F. Supp. 1409, 1428 n.18 (W.D. Mich. 1989) (“with only two firms in the market, the firms would be able to police cheating, or non-collusive pricing by their competitor.”). In almost 100 years of Clayton Act litigation, no court has ever permitted a merger-to duopoly, except where entry barriers were insubstantial.

Why does reducing the number of competitors matter? Because as former Judge Bork instructed, “[w]here rivals are few, firms will be able to coordinate their behavior, either by overt collusion or implicit understanding, in order to restrict output and achieve profits above competitive levels.” *FTC v. PPG*, 798 F.2d, 1500 1503 (D.C. Cir. 1986). As the D.C. Circuit Court observed in its seminal decision in *Heinz*: “The combination of a concentrated market and barriers to entry is a recipe for price coordination.” 246 F.3d at 724. It is settled law that “significant market concentration makes it ‘easier for firms in the market to collude,

expressly or tacitly, and thereby force price above or farther above the competitive level.’” *FTC v. University Health*, 938 F.2d 1206, 1218 n.24 (11th Cir. 1991). As concentration increases the “greater is the likelihood that parallel policies of mutual advantage not competition will emerge.” *United States v. Aluminum Co. of America*, 377 U.S. 271, 280 (1964). Further, as Justice Kennedy has observed, the threat is that “firms in a concentrated market might in effect share monopoly power, setting their shared economic interests and their interdependence with respect to price and output decisions.” *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 227 (1993).

There are significant reasons for competitive concerns in the express package delivery service market. There are few competitors, homogeneous products, in a market with high entry barriers. The market is quite similar to air cargo market in which the Justice Department has secured almost \$1.3 billion in fines to date against several airlines for fixing the cargo rates charged to customers for international air shipments. This cartel has cost consumers billions of dollars in higher prices.

I am not suggesting that after a DHL/UPS merger UPS and Federal Express would explicitly collude – they would not need to. Simply, by removing DHL from the competitive playing field, UPS and Federal Express will not have to compete as aggressively and may be able to follow each other’s lead in raising prices and reducing service. A merger is illegal under Section 7 of the Clayton Act if the remaining firms will be more likely to engage in conduct that may result in higher prices, even if that conduct, in itself, would be lawful.

A potential merger, or more likely this alliance, raises the very competitive problem – a tightening of oligopoly market conditions – that lies at the heart of Section 7. As the D.C. Circuit recently observed in condemning a merger that reduced the number of competitors from three to two, potential tacit coordination:

is feared by antitrust policy even more than express collusion, for tacit coordination, even when observed, cannot easily be controlled directly by the antitrust laws. It is a central object of merger policy to obstruct the creation or reinforcement by merger of such oligopolistic market structures in which tacit coordination can occur.

*Heinz* 246 F.3d at 725;quoting 4 Phillip E. Areeda, Herbert Hovenkamp & John L. Solow, *Antitrust Law* P 901b2, at 9 (rev. ed. 1998).

Let me give you an example of this, the DOJ's successful challenge to UPM Kymmene's proposed acquisition of a rival labelstock firm, Morgan Adhesives Company (MACtac).<sup>4</sup> UPM and MACtac were the second and third largest North American producers of pressure sensitive labelstock, the base material used for shipping and supermarket scale labels, and the merger would have increased UPM's market share from 12% to 19%. A major rationale for the merger was the weakened financial condition of MACtac which had suffered several years of significant losses and faced a very uncertain future. The merger reduced the number of competitors from 5 to 4, but the merged firm, along with the largest firm, Avery, would have controlled about 70% of the label stock market. The DOJ challenged the merger because it would facilitate price coordination between the merged firm and Avery.

The Court enjoined the merger holding that the merger would enhance the potential for coordination because MACtac had excess capacity that served as a disruptive force in the market. Moreover, coordination between Avery and UPM was more likely because Avery was a significant customer of UPM. The transaction would have facilitated tacit cooperation by eliminating the acquired firm's threat of competition due to its excess capacity.

UPM testified that its U.S. subsidiary had every intention of competing vigorously with Avery. The CEO of UPM impressed the court as a tough competitive leader who would try to "annihilate" Avery. The court also noted that UPM had built a Chinese wall to isolate UPM's business with Avery from its U.S. subsidiary's competition with Avery. But even that sincere intent to compete aggressively and the firewall were insufficient to permit the merger. Eliminating the potential disruptive force of MACtac would enhance collusion. As a result, the court enjoined the merger concluding that the merged entity, along with Avery, could maintain a 5-10% increase in price, at least for a year or two.

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4. *United States v. UPM-Kymmene*, 2003 U.S. Dist. LEXIS 12820 (N.D. Ill. July 25, 2003), available at <http://www.usdoj.gov/atr/cases/f201100/201196.htm>. I was one of the attorneys who defended UPM.

## **Even an Arrangement Short of a Merger will Raise Substantial Competitive Concerns**

The parties obviously have been counseled well enough not to propose a merger that the agencies and courts would return as a “dead letter.” Instead they have suggested an arrangement short of a merger in which UPS will handle all of the transportation services for DHL except local delivery. Although the parties have not reached a final agreement the envisioned arrangement raises serious competitive concerns that should be thoroughly investigated by antitrust enforcers before the arrangement takes effect.

Alliances between competitors are not immune from antitrust scrutiny, as suggested by the parties. Rather, they can be challenged under Section 1 of the Sherman Act as an unreasonable restraint of trade. For decades the courts have enjoined a wide variety of arrangements among competitors including the type of joint service agreement proposed by the parties in this case.

Let me be clear, a wide variety of joint ventures, strategic alliances, and supply and purchase agreements among competitors are permissible under the antitrust laws. One of the crucial innovations in antitrust law in the past generation is the increasing recognition of the need for such arrangements in fostering rivalry and competition. To provide greater flexibility was one of the reasons Congress passed the National Cooperative Research Act in 1984 and amended the Act (the National Cooperative Research and Production Act (“NCRPA”)) in 1993 to include production joint ventures.

However, the essential inquiry under both the Sherman Act and the NCRPA is whether the firms retain the incentive and ability to fully compete after the arrangement. If the arrangement diminishes either the incentive or ability to compete, serious competitive concerns may be raised. Those concerns are most significant in a market like this one with high entry barriers and less than a handful of competitors.

What will be the impact of the so-called “supply arrangement” on DHL’s role as an independent competitor and its incentive and ability to compete?

- DHL will be dependent on UPS for all of its entire air transportation services. This is not a supply agreement for a minor input such as boxes, trucks, or local transport in some locations. Rather air transport is the most critical cost component in the delivery of express packages. Through this arrangement DHL will be wholly dependent on UPS for its most critical cost component. As the Ohio delegation has observed, through this arrangement “DHL will surrender control over cost and service quality to one of its chief competitors.”<sup>5</sup> In this setting, it is hard to imagine how DHL will have the ability to challenge UPS and Federal Express by lowering prices or improving service. In response, UPS can easily “discipline” DHL by mismanaging deliveries, increasing costs, or reducing service.
- Through this arrangement UPS can gather a wealth of competitively sensitive information about DHL’s customers, pricing, and competitive initiatives. With this information UPS can selectively target DHL customers offering them special discounts and other services. After all these are extremely sophisticated firms, that gather vast amounts of competitive information. The parties may suggest that firewalls may prevent this conduct, but recall that proposed firewalls were insufficient in the UPM case which posed far less significant competitive concerns. In any case, DHL will quickly recognize UPS’ power to steal customers and retaliate and this will dampen both DHL’s incentive and ability to compete.
- Through this arrangement UPS will be able to engage in a price squeeze, by raising DHL’s costs while reducing prices to UPS customers. Express package delivery services are an important cost center for cost-conscious businesses, which will switch for a savings of less than a penny per package. It is difficult to imagine how DHL could successfully respond to such a strategy which clearly would raise DHL’s costs and diminish its ability to compete.

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<sup>5</sup> Letter from Ohio Delegation to Thomas O. Barnett and William E. Kovacic (July 15, 2008).

Not surprisingly, one major industry expert concluded “The loss of DHL from the competitive landscape over time is going to result in higher prices for shippers. For all intents this eliminates from the marketplace the low-priced competitor.”<sup>6</sup>

Some may argue that there is no precedent that a supply agreement can enhance the likelihood of collusion. They are mistaken. Take the UPM example. As the DOJ observed in its complaint the UPM/Avery supply arrangement “provides UPM and [Avery] with the motivations, opportunities, and means to coordinate on price, monitor adherence, punish cheating, and engage in side payments” that enhanced the ability and incentive to collude. UPM’s supply arrangement with Avery appeared to diminish the incentive to compete – after all why would you steal sales from one of your major customers? Indeed, there was evidence of collusion in the paper labelstock market that was cited in the DOJ merger case; it eventually led to an EU antitrust investigation, a U.S. criminal investigation, and several private antitrust suits that are pending.

I could envision that UPS and DHL may make commitments similar to those made in the UPM/MACtac merger to compete aggressively and to firewall competitively sensitive issues. Those commitments should be carefully investigated by the antitrust enforcers. As the UPM case instructs those commitments may not be sufficient to eliminate competitive concerns. And the UPM case was in a far less concentrated market than this one.

I understand the parties suggest this arrangement is not problematic because the US Postal Service has a similar arrangement with Federal Express. I am not sure that the fact that the Justice Department has chosen not to sue the U.S. Postal Service means much, since U.S. taxpayers probably do not want their tax dollars spent on different federal agencies suing each other. In any case, the arrangement actually demonstrates that competitive concerns are likely: since the Postal Service entered into the arrangement its market share has decreased significantly. Why should we expect anything different from a UPS/DHL arrangement?

Let me provide a simple example that may illustrate the competitive concerns. Assume there are only three commercial airlines in the United

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<sup>6</sup> “Priced to Move” Trafficworld Online (June 16, 2008) (quoting Gerald Hempstead).

States, with market shares similar to those in this market. The second largest airline proposes to enter into an arrangement in which it provides all the airplanes and flight services for the smaller third firm. Even if the third airline continues to have ticket agents, does its own advertising, and “sets” its own prices, would we conclude that competition would not be harmed and consumers pay more? Of course not.

That is why this “alliance” must be fully investigated by the antitrust agencies before it goes forward.

### **DHL’s Weakened Financial Status does not Justify the Arrangement**

I can envision that the parties will argue that the merger is justified by DHL’s significant losses and weakened competitive condition. The antitrust laws and the Merger Guidelines permit the approval of an otherwise anticompetitive merger in certain limited conditions: basically where the firm is on the verge of going bankrupt and there is no less anticompetitive purchaser. This is an extremely stringent defense, and there have been less than a handful of cases permitting mergers on this basis. Indeed, the courts have called it one of the weakest of antitrust defenses.<sup>7</sup>

The stringent attitude toward financial weakness as a defense has a sound basis. Firms should not be given a “pass” from antitrust scrutiny just because costs increase, a firm is badly managed, or the market diminishes. After all a “merger is forever” and any of those factors can change. Moreover, market conditions can improve for any of a number of reasons.

Let’s return to the UPM case for an illustration. The defendants argued that the merger was not anticompetitive because the acquired firm, MACTac, had suffered significant losses and was not a viable future competitor. The court rejected the “weakened-competitor” argument, because a merger does not become permissible merely because the entity to be merged is competing poorly. Indeed, the Court held the weakened competitor argument, of itself “certainly cannot be the primary basis for

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<sup>6-7</sup> *Ivaco*, 704 F. Supp. at 1424 (“financial weakness, while perhaps relevant in some cases, is probably the weakest ground of all for justifying a merger.”) (citing *Kaiser Aluminum & Chem Corp. v. FTC*, 652 F.2d 1324, 1338 (7th Cir. 1981).

permitting a merger.”<sup>8</sup> Indeed, the defendants’ predictions of demise were mistaken and MACtac continues to compete in the market to this day.

The claim that “but for” a merger a firm will go out of business or cease to be a significant competitor is frequently made and rarely born out in history. Several years ago I authored a law review article which reviewed mergers that the FTC successfully challenged in which the parties suggested that “but for” the merger the acquired firm would go out of business or cease to be competitive. In each case that prediction, like the prediction of Mark Twain’s death, was mistaken. In some cases the firm reorganized or found new financial support; in other cases the firm was acquired by an alternative purchaser that did not pose competitive problems. In each, case consumers benefitted by rejecting an otherwise anticompetitive merger.

### **The Antitrust Agencies Should Immediately Open an Investigation of the Potential Arrangement**

I believe that in spite of concerns raised about the alliance in June and July by both of the Presidential candidates, Senators Kohl and Hatch, and several members of the Ohio delegation in letters to the Assistant Attorney General of the Antitrust Division and the Chairman of the Federal Trade Commission, neither agency has opened an investigation. Since the existence of an investigation is non-public, I may be mistaken. But if the agencies have not begun to investigate that is a mistake.

As I noted before, since this arrangement is not reportable under the Hart-Scott-Rodino Act, the parties can consummate the arrangement immediately after the agreement is reached. Once the agreement is reached the market will be irretrievably changed. Moreover, once the agreement takes effect customers may be reluctant to cooperate with the agencies and complain about the arrangement, fearing retaliation from UPS. The time to secure information about the potential effects of this arrangement is now, not after DHL becomes a captive passenger on the UPS railroad.

As a former antitrust enforcer, I can understand the reluctance of investigating before all the details of the arrangement are announced. But even in this preliminary period the agencies can secure information on a

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<sup>7-8</sup> *UPM-Kymmene*, 2003 U.S. Dist. LEXIS 12820, at \*29, citing *Kaiser Aluminum & Chem Corp. v. FTC*, 652 F.2d 1324, 1341 (7th Cir. 1981).

wide range of critical issues, including the alternatives of customers, the potential for entry, the likelihood of collusion and past competitive initiatives by DHL and UPS.

Finally, I must observe for this Committee, which has jurisdiction over the enforcement of the antitrust laws that the current level of merger enforcement is substantially below that of previous administrations. A recent article published by the former chief economists of the Federal Trade Commission and the Antitrust Division of the Department of Justice strongly substantiates that merger enforcement appears to be significantly more lax than in the prior administrations. They found “with no change in the underlying statute, the Clayton Act, the weight given to market concentration by the federal courts and by the federal antitrust agencies has declined dramatically.”<sup>9</sup> Indeed, the Antitrust Division of the Justice Department has not been to court seeking to enjoin a merger in over 4 years, an unprecedented period of merger nonlitigation.

Let me raise a final concern. This “arrangement” was announced over 90 days ago. While this arrangement is being considered one can imagine that competition between DHL and UPS is significantly dampened. Indeed, while the transaction is considered DHL’s incentives to compete are diminished and both consumers and employees suffer from the uncertainty, while DHL withers on the vine. Indeed, DHL has already cut back on service in several markets. Thus, the Committee should ask the parties to be precise about their plans to reach this agreement and their obligations to preserve competition while the agreement is being negotiated.

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<sup>8,9</sup> Jonathan B. Baker and Carl Shapiro, “Reinvigorating Horizontal Merger Enforcement” (Oct. 2007).