

Will the New Guidelines Clarify or Obscure Antitrust Policy?

Dennis W. Carlton and Mark Israel

The new Horizontal Merger Guidelines (2010 Guidelines) do an excellent job of summarizing how the government agencies currently analyze mergers.¹ They codify what most experienced antitrust practitioners likely knew or surmised from the recent commentaries published by each of the agencies. But experienced antitrust practitioners are not the only audience for the Guidelines. The courts and foreign antitrust agencies are another important audience. They use the Guidelines not just to understand what U.S. agencies might do, but also to help define and implement a reasonable antitrust policy. It is to this audience that we fear the new 2010 Guidelines could make antitrust principles and practice less clear.

In this essay, we discuss three concerns with the recent changes to the Guidelines, each of which risks making antitrust analysis more opaque, rather than more clear, to courts and foreign antitrust agencies. These concerns are: the de-emphasis of the use of market definition as a tool in antitrust analysis, the failure to emphasize properly the importance of non-price competition and fixed cost efficiencies that can stimulate that competition, and the excessive focus on particular techniques (with weaknesses that may not be well understood by courts and others) rather than general principles.²

Adverse Effects of Downplaying the Use of Market Definition

A central question in merger analysis is whether the merged firm would acquire sufficient additional market power as a result of the merger to enable it to raise price above the level that would otherwise have prevailed. Frequently, the initial step in a merger analysis is defining a market and then seeing whether the resulting increase in concentration post-merger would likely lead to an increase in price. The 2010 Guidelines de-emphasize the need to define a market if other methods can establish that a merger will lead to a price increase.

The difficulties with market definition are well known to antitrust practitioners.³ To identify rigorously the proper market definition requires applying sophisticated econometric methods to data. However, if one has faith in these methods and in the data, they can be used directly to identify the price effects of the merger. So, to many experienced antitrust practitioners, the natural question is: why even bother with the intermediate step of market definition? Why not skip right to a study of the pricing effects of interest?

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¹ U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (2010) [hereinafter 2010 Guidelines], available at <http://www.ftc.gov/os/2010/08/100819hmg.pdf>.

² These topics as well as other limitations of the 2010 Guidelines are discussed in detail in Dennis W. Carlton, Comment on Department of Justice and Federal Trade Commission Proposed Horizontal Merger Guidelines (June 4, 2010), available at <http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00034.pdf>; Dennis W. Carlton, Use and Misuse of Empirical Methods in the Economics of Antitrust, Keynote Address, Annual Conference of the Competition Law and Policy Institute of New Zealand (2010) [hereinafter Carlton 2010 Keynote Address]; Dennis W. Carlton, *Revising the Horizontal Merger Guidelines*, 6 J. COMPETITION L. & ECON. 619 (2010).

³ See, e.g., Dennis Carlton, *Market Definition: Use and Abuse*, COMPETITION POL'Y INT'L, Spring 2007.

The answer is that, particularly for users of the Guidelines with relatively little antitrust experience, market definition has one overwhelming advantage. It is easy to use. One does not need a Ph.D. in economics to understand how to use it once it has been established. This means that courts or competition authorities not staffed with lots of highly trained economists can have some grounding in making antitrust decisions. To eliminate market definition would likely lead to arbitrariness and discretionary havoc in courts and at foreign agencies where economics is not as well understood as at U.S. antitrust agencies. Therefore, though we recognize its severe limitations, market definition—based on a variety of (sometimes qualitative) evidence as to which products constrain price, perhaps combined with a confirming econometric analysis—should remain an important tool for antitrust analysis. If courts and foreign agencies rely on the 2010 Guidelines as a basis to justify ignoring or downplaying market definition as a tool of merger analysis, this is likely to lead to less effective antitrust policy.

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The Understatement of the Value of Non-Price Competition

The 2010 Guidelines mention the potential value of non-price competition, such as innovation to produce new or improved products. For example, in discussing efficiencies, the 2010 Guidelines correctly indicate that efficiencies can come from “improved quality, enhanced service, or new products” in addition to “lower prices.”⁴ The 2010 Guidelines also correctly indicate that efficiencies “relating to costs that are fixed in the short term . . . can benefit customers in the longer run, e.g., if they make new product introduction less expensive.”⁵

However, relative to the attention paid to price competition, the 2010 Guidelines could be interpreted as placing too little emphasis on non-price competition. For example, the discussion of fixed cost savings is relegated to a footnote in the 2010 Guidelines, which notes that, although the benefits from fixed costs occur in the longer run, “[t]he Agencies normally give the most weight to the results of this analysis over the short term.”⁶ And while the 2010 Guidelines note the possibility of efficiencies from improved product quality, they also indicate that “the Agencies consider whether cognizable efficiencies likely would be sufficient to reverse the merger’s potential to harm customers in the relevant market, e.g., by preventing price increases in that market.”⁷ This language does not appear to give as much credit to non-price effects, such as new and improved products that might benefit consumers even if they do not “prevent price increases.” Failure to credit those effects would be unfortunate because the economic literature recognizes that much of the gain in consumer welfare over time can be attributed to technological innovations and new products.

We are concerned that the Guidelines could be interpreted in a way that leads courts and others to stop beneficial mergers in industries characterized by high levels of R&D and intense competition to innovate (e.g., telecommunications and pharmaceuticals, among others). The benefits from those mergers often flow from merger-enabled reductions in fixed costs and the associated increase in incentives to invest in R&D and introduce new products. Failure to account adequately for the effect of mergers on those incentives could cause agencies to challenge mergers that would foster innovation and enhance consumer welfare.

⁴ 2010 Guidelines, *supra* note 1, § 10.

⁵ *Id.* § 10 n.15.

⁶ *Id.*

⁷ *Id.* § 10.

Overemphasis on Particular Analytical Techniques

Whereas the previous Guidelines focused attention primarily on general principles for the analysis of antitrust, sometimes at the expense of details on the implementation of those principles,⁸ the 2010 Guidelines make more extensive reference to specific economic or econometric techniques that may be useful as part of an antitrust analysis. As a description of what the Agencies may actually do in an antitrust analysis, identifying specific techniques may be useful. However, we worry that identification of specific techniques may codify methods that are in vogue today (in some cases, despite a lack of empirical evidence establishing their usefulness) but may fall out of favor tomorrow based on additional research. Moreover, even if the techniques remain popular, courts and other users of the 2010 Guidelines may struggle to know which techniques to apply in particular circumstances and what caveats need to be considered when interpreting results.

In the remainder of this section, we discuss concerns with specific techniques discussed in the Guidelines: one old one (the use of HHI thresholds), and two relatively new ones (upward pricing pressure and merger simulation).

The Lack of Empirical Support for the New HHI Thresholds. Like previous versions of the Guidelines, the 2010 Guidelines include HHI “thresholds,” both as a screen to determine which mergers are likely to “warrant scrutiny” and as a way to define mergers that are presumed “to be likely to enhance market power.”⁹ Although the 2010 Guidelines have raised the HHI thresholds for “unconcentrated,” “moderately concentrated,” and “highly concentrated” markets from the thresholds in the previous Guidelines, this does not mean that the 2010 Guidelines have relaxed the stringency of merger review. Rather, increasing the thresholds likely brings the 2010 Guidelines more in line with actual agency practice than did the previous version of the Guidelines.

In addition, regardless of the precise cutoff levels used, it would be a mistake for courts to infer from the fact that there are new HHI thresholds in the 2010 Guidelines that there has been any new research to justify giving special credence to these new thresholds. Indeed, we know of no body of economic research that provides either an econometric or a theoretical basis for the HHI thresholds in the 2010 Guidelines (or for that matter in previous versions of the Guidelines).¹⁰ In any event, the value of any such general HHI thresholds for merger review is extremely limited since we know the effect of industry concentration on price varies enormously across industries. At best, such general HHI thresholds, if based on empirical evidence that relates the thresholds to the likely effects of mergers, could be used as a rough screen for identifying those mergers that might merit further investigation.

Upward Pricing Pressure and Merger Simulation. While the 2010 Guidelines do not refer explicitly to the “Upward Pricing Pressure” method (UPP) for evaluating mergers involving differentiated products, Section 6.1 of the new Guidelines (on unilateral effects) uses the phrase “upward pricing pressure” and refers to many of the concepts developed in Farrell and Shapiro’s paper on the method.¹¹ It therefore seems highly likely that courts, practitioners, and foreign antitrust agen-

⁸ U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines (1992, rev. 1997), available at <http://www.justice.gov/atr/public/guidelines/hmg.pdf>.

⁹ 2010 Guidelines, *supra* note 1, § 5.3.

¹⁰ Carlton, *supra* note 3, explains when and how various proposed market definitions can be tested empirically and how this type of confirmation can be used to predict the effect of a particular increase in HHI on price. That effect is likely to vary by industry. Hence, general HHI thresholds can be at best a very crude guide.

¹¹ Joseph Farrell & Carl Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition*, B.E. J. THEORETICAL ECON.: POLICIES & PERSPECTIVES, vol. 10, issue 1, art. 9 (2010), <http://www.bepress.com/bejte/vol10/iss1/art9>.

cies will see the discussion of unilateral effects as implicitly referencing and endorsing UPP as a method for the review of differentiated products mergers.

Despite its simple form, proper application of the UPP methodology raises issues that may create difficulties for all but the most sophisticated users. For example, in their paper, Farrell and Shapiro recognize that, while UPP looks at price effects for each product in isolation (holding the price of all other products at their pre-merger levels), actual price effects depend on the feedback between the price changes of various products. In particular, they discuss the effect of a marginal cost efficiency for one product on the prices of other products involved in the merger, noting that UPP “does not account for the fact that any cost reduction in Product 2 will raise Product 2’s margin and thus raise the value of sales diverted to Product 2 when the price of Product 1 rises.”¹² The implication they draw is that the feedback effects make the use of UPP conservative.¹³ This need not be the case. In particular, to the extent that efficiencies from the merger lower the marginal cost of Product 2, this will tend to *reduce* the price of Product 2, which will in turn put *downward pressure* on the price of Product 1. This effect is completely ignored by UPP. As a result, in the presence of substantial efficiencies, UPP may substantially overpredict a merger’s likely effect on prices.

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This is one example of the many caveats with UPP that are generally well understood by those who use the method. None of these caveats implies that the method is not useful if properly applied and interpreted. But they do suggest a real risk that improper conclusions could be reached if, in an attempt to follow the methods listed in the 2010 Guidelines, the methods are used without full appreciation of all the associated nuances.

Finally, in addition to discussing upward pricing pressure, the 2010 Guidelines discuss merger simulation.¹⁴ We simply point out that we are unaware of any empirical studies showing the usefulness of UPP as a method to screen mergers and that there is only weak empirical evidence establishing the usefulness of merger simulation as a tool to predict anticompetitive mergers.¹⁵

Conclusion

The 2010 Guidelines do an excellent job of describing how the antitrust agencies currently analyze mergers. Our primary concern with the 2010 Guidelines is that their de-emphasis of the use of market definition plus their failure to spell out the limitations of the methods discussed may lead to confusion and less effective antitrust policy among audiences that rely on the 2010 Guidelines to formulate and implement antitrust policy, including the courts, practitioners and foreign antitrust agencies. Continued discussion of the 2010 Guidelines may mitigate that confusion. ●

¹² *Id.* at 12.

¹³ *Id.* at 13–14.

¹⁴ 2010 Guidelines, *supra* note 1, § 6.1.

¹⁵ See, e.g., Dennis Carlton, *Why We Need to Measure the Effect of Merger Policy and How to Do It*, COMPETITION POL’Y INT’L, Spring 2009; Carlton 2010 Keynote Address, *supra* note 2.