# Editor's Note:
# Symposium on the 2010 Horizontal Merger Guidelines

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This issue of the *Antitrust Source* features a series of articles by distinguished antitrust practitioners on the new horizontal merger guidelines.[1] While the *Source* has published numerous articles on the proposed merger guidelines revisions,[2] this symposium provides the first collection of essays on the 2010 Guidelines. The essays are not intended to be a comprehensive discourse but are purposely limited to one or two key points on which each author wanted to focus.

There has been a general awareness in the antitrust community that an update to the seventeen-year-old Horizontal Merger Guidelines[3] was appropriate, but it is likely that the close working relationship and similarity of views between the current chief economists at the Federal Trade Commission and the Department of Justice acted as the tipping point that led to the release of revised guidelines this year.

## The First Merger Guidelines

Before the 1990s, the longest economic expansion by the American economy began in March 1961. The bulls charged throughout the Kennedy-Johnson years and into the first ten months of the Nixon administration.[4] In the midst of that expansion and associated merger wave, Donald F. Turner, in his first speech as the Antitrust Division's Assistant Attorney General, spoke of the need for a set of rules to assist the Division and private bar in merger analysis.[5] This eventually led to the first set of merger guidelines being promulgated on May 30, 1968.[6]

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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 David Scheffman & Joseph Simons, *Unilateral Effects with Differentiated Consumer Products: A Response to Werden*, ANTITRUST SOURCE, Aug. 2010, http://www.abanet.org/antitrust/at-source/10/08/Aug10-Scheffman8-2f.pdf; Gregory J. Werden, *Unilateral Effects with Differentiated Consumer Products: A Response to Scheffman and Simons*, ANTITRUST SOURCE, June 2010, http://www.abanet.org/antitrust/at-source/10/06/Jun10-Werden6-24f.pdf; David Scheffman & Joseph Simons, *Unilateral Effects for Differentiated Products: Theory, Assumptions, and Research*, ANTITRUST SOURCE, Apr. 2010, http://www.abanet.org/antitrust/at-source/10/04/Apr10-Scheffman4-14f.pdf; Timothy J. Muris & Bilal Sayyed, *Three Key Principles for Revising the Horizontal Merger Guidelines*, ANTITRUST SOURCE, http://www.abanet.org/antitrust/at-source/10/04/Apr10-Muris4-14f.pdf; Serge Moresi, *The Use of Upward Price Pressure Indices in Merger Analysis*, ANTITRUST SOURCE, Feb. 2010, http://www.abanet.org/antitrust/at-source/10/02/Feb10-Moresi2-25f.pdf; Elizabeth M. Bailey et al., *Merger Screens: Market Share-Based Approaches Versus "Upward Pricing Pressure,"* ANTITRUST SOURCE, Feb. 2010, http://www.abanet.org/antitrust/at-source/10/02/Feb10-Leonard2-25f.pdf; Peter Boberg & John Woodbury, *Repositioning and the Revision of the Horizontal Merger Guidelines*, ANTITRUST SOURCE, Dec. 2009, http://www.abanet.org/antitrust/at-source/09/12/Dec09-Boberg12-17f.pdf; Darren S. Tucker, *Seventeen Years Later: Thoughts on Revising the Horizontal Merger Guidelines*, ANTITRUST SOURCE, Oct. 2009, http://www.abanet.org/antitrust/at-source/09/10/Oct09-Tucker10-23f.pdf; Ilene Knable Gotts & Étienne Renaudeau, *Through the Looking Glass: Ruminations on Improving the Current U.S. Merger Enforcement Guidelines*, ANTITRUST SOURCE, Apr. 2009, http://www.abanet.org/antitrust/at-source/09/04/Apr09-Gotts4-28f.pdf.

3 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.

4 JAMES R. WILLIAMSON, FEDERAL ANTITRUST POLICY DURING THE KENNEDY-JOHNSON YEARS 56 (1995).

5 Donald F. Turner, *Antitrust Enforcement Policy*, 29 A.B.A. ANTITRUST SECTION 187 (1965).

6 U.S. Dep't of Justice, Merger Guidelines (1968), *available at* http://www.justice.gov/atr/hmerger/11247.pdf.

While the concept of merger guidelines was novel in the 1960s, the consensus was that the 1968 Guidelines contained nothing new and thus were of little use.[7] The market share thresholds had already been approximated by the private bar, and the rules were all to be found in recent Supreme Court decisions.[8] As a result, Turner's guidelines were all but forgotten less than a decade after their release.[9] This similarity to commentary on the 2010 Guidelines—that they contain nothing new—could be concerning.[10] The 2010 Guidelines will likely prove more memorable than the 1968 Guidelines, however, not necessarily because they contain concepts hitherto unknown to antitrust practitioners, but because they accurately reflect current agency practice[11] that has evolved since the last major revision to the horizontal merger guidelines in 1992.[12] They also provide strong signals to what the agencies consider best practices.

## Calls to Redraft the 1992 Guidelines and Challenges to Overcome

The calls to update the horizontal merger guidelines have gradually increased in frequency over the last couple of years. Both before and after FTC Chairman Jon Leibowitz and DOJ AAG Christine Varney announced plans to hold workshops to consider updating the 1992 Guidelines on September 22, 2009,[13] many antitrust practitioners had published articles identifying the need for a revised set of horizontal merger guidelines.[14] The growing consensus was that despite the agencies' efforts to keep the public informed of their "evolving interpretation of the Guidelines" through closing statements, speeches, workshops, merger enforcement dates, and most notably the 2006 Merger Guidelines Commentary, the "growing patchwork of glosses on the Guidelines ha[d] become unwieldy for all but the most seasoned veterans of the antitrust agencies."[15]

One of the main challenges that seemed to face the agencies was whether they would agree with each other on revisions. The agencies have diverged over some fundamental aspects of policy in recent years. The most striking example of differences between the agencies was when

[7] Gregory J. Werden, *Should the Agencies Issue New Merger Guidelines?: Learning From Experience*, 16 GEO. MASON L. REV. 839, 841 (2009).

[8] *See* WILLIAMSON, *supra* note 4, at 67.

[9] *See* Werden, *supra* note 7, at 841.

[10] Statement of Chairman Leibowitz on the Release of the 2010 Horizontal Merger Guidelines (Aug. 19, 2010), *available at* http://www.ftc.gov/os/2010/08/100819hmgleibowitz.pdf ("the new Guidelines provide a clearer and more accurate explanation to merging parties, courts, and antitrust practitioners of how the agencies review transactions."); David P. Wales & Craig A. Waldman, What You Need to Know About the Revisions to the Merger Guidelines, JONES DAY COMMENTARY (Apr. 2010), *available at* http://www.jonesday.com/what_you_need_to_know/ ("However, despite some anxiety over what the new administration might do to dramatically raise the bar for mergers, the revisions predominantly reflect mainstream antitrust principles and, importantly, more accurately describe the current state of merger review at the agencies.").

[11] Although some may disagree. *See* Statement of Commissioner J. Thomas Rosch on the Release of the 2010 Horizontal Merger Guidelines (Aug. 19, 2010), *available at* http://www.ftc.gov/os/2010/08/100819hmgrosch.pdf ("These Guidelines do not describe the way that the Bureau of Competition and enforcement staff at the Commission proceed today.").

[12] U.S. Dep't of Justice & Fed. Trade Comm'n Statement Accompanying Release of Revised Merger Guidelines, 4 Trade Reg. Rep. (CCH) ¶ 13,104 (Apr. 2, 1992).

[13] Press Release, Fed. Trade Comm'n, Federal Trade Commission and Department of Justice to Hold Workshops Concerning Horizontal Merger Guidelines (Sept. 22, 2009), *available at* http://www.ftc.gov/opa/2009/09/mgr.shtm; Christine A. Varney, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Merger Guidelines Workshops (Sept. 22, 2009), *available at* http://www.usdoj.gov/atr/public/speeches/250238.pdf; Remarks of FTC Chairman Jon Leibowitz as Prepared for Delivery at the Third Annual Georgetown Law Global Antitrust Enforcement Symposium (Sept. 22, 2009), *available at* http://www.ftc.gov/speeches/leibowitz/090922mergerguideleibowitzremarks.pdf.

[14] *See, e.g.*, Tucker, *supra* note 2; Gotts & Renaudeau, *supra* note 2.

[15] Tucker, *supra* note 2, at 3.

three of the four FTC Commissioners criticized the DOJ's 2008 Single-Firm Conduct Report. The DOJ retracted their report shortly thereafter.[16]

During the course of the workshops that the agencies held to discuss topics likely to be addressed in the revised guidelines, it became clear that many panelists thought that the heads of the Bureau of Economics at the FTC and the Economic Analysis Group at the DOJ would exert more than a marginal influence on the drafting of the next set of guidelines. This was hardly surprising because Joe Farrell and Carl Shapiro were on the faculty at the University of California-Berkeley together, co-authored numerous articles on merger analysis, and both served as deputy attorneys general at the DOJ. Their close working relationship and Farrell's experience at both agencies likely helped bridge any differences that might have existed between the two agencies during the drafting process.[17] Their association and early work also appeared to signal what the revised merger guidelines would emphasize. These were themes that were not necessarily new, but ended up shaping how the 2010 Guidelines were presented.

## The Farrell and Shapiro Dynamic

Significantly, Farrell and Shapiro had been highly critical of the linear approach to investigating mergers. In a 2008 paper, they argued that the step-by-step process in the 1992 Guidelines to assess whether a challenge to a horizontal merger was appropriate was inconsistent with modern economics and "has created a tangle of problems."[18] It was of little surprise then that the 2010 Guidelines depart from this linear approach and describe a flexible analysis that explains how a number of elements could be used to investigate a merger. Since the agencies had long stopped following a linear approach in favor of a more holistic analysis, this was a welcome change to the text, but not a change in practice.

The 2010 Guidelines do, however, hint at a new "merger screen" incorporated from some of Farrell's and Shapiro's earlier work. The 2010 Guidelines discuss the use of "upward pricing pressure" to diagnose markets with differentiated products. Farrell and Shapiro developed the Upward Pricing Pressure (UPP) method in a series of articles while at Berkeley.[19] UPP is based on pre-merger gross margins of the merging parties and estimates of the diversion ratios between their products. The use of pre-merger gross margins and diversion ratios has been standard agency practice over the last decade.

Before the 2010 Guidelines came out, commentators had already started to speculate about the role of UPP in the new guidelines.[20] Serge Moresi described the benefits of the UPP method-

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[16] Commissioners Harbour, Leibowitz, and Rosch described the DOJ's Section 2 Report as a "blueprint for radically weakened enforcement of Section 2 of the Sherman Act." Statement of Commissioners Harbour, Leibowitz and Rosch on the Issuance of the Section 2 Report by the Department of Justice (Sept. 8, 2008), *available at* http://www.ftc.gov/os/2008/09/080908section2stmt.pdf.

[17] *See, e.g.*, Joseph Farrell & Carl Shapiro, *How Strong Are Weak Patents?*, 98 Am. Econ. Rev. 1347 (2008); Jonathan B. Baker, Joseph Farrell & Carl Shapiro, *Merger to Monopoly to Serve a Singe Buyer: Comment*, 75 Antitrust L.J. 637 (2008); Joseph Farrell & Carl Shapiro, *Improving Critical Loss Analysis*, Antitrust Source, Feb. 2008, http://www.abanet.org/antitrust/at-source/08/02/Feb08-Farrell-Shapiro.pdf; Joseph Farrell, John Hayes, Carl Shapiro & Theresa Sullivan, *Standard Setting, Patents, and Hold-Up*, 74 Antitrust L.J. 603 (2007); Joseph Farrell & Carl Shapiro, *Scale Economies and Synergies in Horizontal Merger Analysis*, 68 Antitrust L.J. 685 (2001); Joseph Farrell & Carl Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition*, 10 B.E. J. Theoretical Econ. (2010), http://www.bepress.com/bejte/vol10/iss1/art9/; Joseph Farrell & Carl Shapiro, *Recapture, Pass-Through, and Market Definition*, 76 Antitrust L.J. 585 (2010).

[18] Farrell & Shapiro, *Antitrust Evaluation of Horizontal Mergers*, *supra* note 17, at 5.

[19] *See supra* note 17.

[20] *See, e.g.*, Moresi, *supra* note 2; Bailey et al., *supra* note 2.

ology as an initial merger screen for differentiated product markets.[21] Alternatively, he outlined the role of UPP in a more complete analysis of competitive effects in conjunction with a number of other factors currently considered in merger analysis. The benefits of UPP as a merger screen were also addressed by Elizabeth Bailey, Gregory Leonard, Steven Olley, and Lawrence Wu.[22] They considered UPP to be an analytical improvement over current market share screens, provided that reliable estimates of three key inputs are available: diversion ratios, gross profit margins, and efficiencies. But the likelihood that reliable data could be assembled during the initial Hart-Scott-Rodino screening period of thirty days seems unlikely. This implied that UPP seemed most appropriate as an analytical tool after parties provided more comprehensive data during the Second Request process. The agencies could, therefore, apply the UPP methodology instead of running merger simulations that require far more data and can be more time consuming.

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Considering the academic work of two of the principal drafters, the discussion of UPP in the 2010 Guidelines is probably less prominent than most commentators expected. The phrase "upward pricing pressure" is used once. In their only mention of UPP, the Agencies carefully tie the concept to diverted sales: "the Agencies assess the value of diverted sales, which can serve as an indicator of the upward pricing pressure on the first product resulting from the merger."[23] By emphasizing that UPP rests on diversion ratios, the Agencies directly link the relatively new with more tried and trusted techniques. This blurring of the lines could counter potential criticisms that the 2010 Guidelines incorporate new methodologies and possibly reflect a bias toward Shapiro and Farrell's previous work.

Along the same lines, the Agencies explain that they do not rely exclusively on UPP to diagnose unilateral effects. Instead, the Agencies stress that they use a "range of analytical tools"[24] in merger analysis of markets consisting of differentiated products. In accordance with the commentators' warnings, the Agencies are careful to point out that merger analysis is highly fact-specific and that upward pricing pressures will only be considered when "sufficient information is available."[25] To emphasize the multiplicity of methodologies available, the Agencies also briefly describe merger simulation models and discuss the more specific concepts of diversion ratios and margins, as well as some of the factual evidence considered including win/loss reports and documentary evidence.[26] Once again, the Agencies emphasize that they have a variety of tools in their merger toolkit allowing for flexible analyses depending on what factual information is available.

## Commentary by Symposium Authors

While the 2010 Guidelines accurately reflect the more flexible analysis already employed by the Agencies, the codification of these changes has generated some criticism. John Harkrider notes that the more flexible approach makes it far less clear whether a merger will be challenged. He suggests that abandoning the linear approach could lead to the possible return of the uncertain

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21 *See* Moresi, *supra* note 2.

22 *See* Bailey et al., *supra* note 2.

23 *See* 2010 Guidelines, *supra* note 1, § 6.1.

24 *See id.* § 1 ("These Guidelines should be read with the awareness that merger analysis does not consist of uniform application of a single methodology. Rather, it is a fact-specific process through which the Agencies, guided by their extensive experience, apply a range of analytical tools to the reasonably available and reliable evidence to evaluate competitive concerns in a limited period of time.").

25 *See id.* § 6.1 ("In some cases, where sufficient information is available, the Agencies assess the value of diverted sales, which can serve as an indicator of the upward pricing pressure on the first product resulting from the merger.").

26 *See id.* § 6.

era of *Von's Grocery*,[27] when a merger that created a combined market share of under 8 percent was found unlawful. By contrast, Dennis Carlton and Mark Israel raise the concern that the identification of specific techniques could lead to what is effectively a codification of certain techniques that may fall out of favor at a later point of time. Joseph Farrell acknowledged that these types of concerns were uppermost in the minds of the Agencies as they tried to strike the right balance.[28] Whether they succeeded may not be known until the Agencies develop a track record of cases in which they apply the 2010 Guidelines.

To set the scene for future merger cases, Deborah Garza and Deborah Feinstein chronicle and discuss the move away from structural presumptions. They also point out possible issues surrounding alternative techniques that include UPP, which Jerry Hausman suggests improving with a "predicted price change bounds" approach. Using the same information required to calculate UPP, Hausman suggests estimating a range of potential price changes instead, which he argues are easier to interpret.

Apart from the general move to a more flexible approach, the symposium authors also focus on a number of other distinct issues. The future treatment of the 2010 Guidelines by the courts is of particular concern, especially whether courts will be prepared to forgo market definition in certain Section 7 cases. Leah Brannon and Kathleen Bradish discuss this issue in detail. Ilene Gotts, and Carlton and Israel, share the apprehension that the de-emphasis of the use of market definition may lead to some confusion and less effective antitrust policy, especially by the courts and foreign antitrust agencies. Gary Zanfagna does not agree that the market definition section deemphasizes the necessity of market definition in merger analysis, noting that the Agencies clarified in the final version of the 2010 Guidelines that they "will normally identify one or more relevant markets in which the merger may substantially lessen competition."[29] Zanfagna concludes that the Agencies would be "unwise to go to court without including market definition in their case."

In sharp contrast to the much discussed question of market definition, an issue that has not yet received much attention from commentators is the incorporation of a hypothetical exclusionary conduct test drawing on concepts developed under Section 2 of the Sherman Act into traditional Section 7 analysis. Bruce Hoffman and Daniel Francis put the spotlight on this issue in their essay. An issue that has generally captured the attention of the antitrust bar is the treatment of dynamic competition and so-called innovation markets. Jay Ezrielev and Janusz Ordover explain that they regard the 2010 Guidelines as falling short by not better integrating dynamic competition into merger assessment. Susan Creighton extends this point by specifically referencing high-tech markets, explaining how the Guidelines reflect a "textbook picture" of a merger framework instead of a "capitalist reality" that captures dynamic innovation. As a result, Creighton concludes that a "disproportionately large percentage of high-tech mergers" fit poorly into the Agencies' current merger framework.

## Not a Destination But a Journey

As with prior iterations of the horizontal merger guidelines, discussion over best practices will con-

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[27] United States v. Von's Grocery Co., 384 U.S. 270 (1966).

[28] *See e.g.*, Joseph Farrell, Remarks at Horizontal Merger Guidelines Review Project Workshop 7 (Jan. 14, 2010), *available at* http://www.ftc.gov/bc/workshops/hmg/transcripts/100114transcriptstanford.pdf ("[I]t's kind of an open-ended inquiry that is both about economics and about process at the same time. In my way of thinking, that's what we're here to discuss and try to figure out, what's the best way to summarize or to describe what is the best, and most useful, and also the most used ways of analyzing that question.").

[29] *See* 2010 Guidelines, *supra* note 1, § 4.

tinue, econometrics will improve, and eventually it will be time to revise the horizontal merger guidelines once again. The 2010 Guidelines have already stirred up many competing viewpoints that will likely be debated for years before there is sufficient consensus upon which to base another set of guidelines. The articles in this symposium touch on many of the hot button issues. We know you will enjoy reading them and hope they will bolster your thinking about future improvements. ●

# The Revised Horizontal Merger Guidelines: Can the Courts Be Persuaded?

Leah Brannon and Kathleen Bradish

The U.S. antitrust enforcement agencies designed the 2010 Merger Guidelines in part to assist the courts "in developing an appropriate framework for interpreting and applying the antitrust laws in the horizontal merger context."[1] But with respect to at least one key issue, the treatment of market definition, there is a significant question as to whether the courts will be persuaded to follow the 2010 Guidelines' approach.

The 2010 Guidelines state that defining a relevant market is useful "to the extent it illuminates [a] merger's likely competitive effects" but note that the exercise "is not an end in itself."[2] Accordingly, the 2010 Guidelines indicate that the Agencies will "normally"—but not always—define a relevant market in merger challenges.[3] This is a notable departure from the 1992 Guidelines, which provided that, in analyzing a prospective merger, "[t]he Agency will first define the relevant product market."[4] In a separate statement, Commissioner J. Thomas Rosch described the new treatment of market definition as a "monumental contribution" that corrects the "misimpression" created by the 1992 Guidelines that defining the market and measuring shares are "'gating items,' without which competitive effects cannot be considered."[5]

Under general principles of administrative law, the Merger Guidelines are a statement of agency enforcement policy that is not binding on the courts.[6] Rather, a court may consider the

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[1] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 1 (2010) [hereinafter 2010 Guidelines], *available at* http://www.ftc.gov/os/2010/08/100819hmg.pdf; Christine A. Varney, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Merger Guidelines Workshops (Sept. 22, 2009) [hereinafter Merger Guidelines Workshops], *available at* http://www.usdoj.gov/atr/public/speeches/250238.pdf at 5 (suggesting that revisions to the guidelines may be useful to the courts).

[2] 2010 Guidelines, *supra* note 1, § 4.

[3] *Id.* This discussion of what the Agencies will do in litigated merger challenges is arguably in some tension with footnote 2 of the 2010 Guidelines, which states that the "Guidelines are not intended to describe how the Agencies will conduct the litigation of cases." The clear statement in the body of the Guidelines regarding what the Agencies will do in litigation seems more telling than footnote 2, and more consistent with the Agencies' repeated comments that the 2010 Guidelines do in fact reflect the Agencies' enforcement plans. *See, e.g.*, Varney, Merger Guidelines Workshops, *supra* note 2, at 1.

[4] U.S. Dep't of Justice & Federal Trade Comm'n, Horizontal Merger Guidelines § 1.1 (1992, rev. 1997) [hereinafter 1992 Guidelines], *available at* http://www.justice.gov/atr/public/guidelines/hmg.pdf; *see also id.* at § 1.0 ("[a] merger is unlikely to create or enhance market power . . . unless it significantly increases concentration and results in a concentrated market, properly defined and measured.").

[5] Statement of Commissioner J. Thomas Rosch on the Release of the 2010 Horizontal Merger Guidelines (Aug. 19, 2010), *available at* http://www.ftc.gov/os/2010/08/100819hmgrosch.pdf. This change may have been designed at least in part to improve the Agencies' odds of winning merger challenges in court. *See, e.g.*, Daniel M. Wall & Hanno F. Kaiser, *What the New Merger Guidelines Mean for Technology Companies* (Apr. 24, 2010), *available at* http://www.lw.com/upload/pubContent/_pdf/pub3492_1.pdf (arguing that showing a substantial lessening of competition in a properly defined relevant market "has been a core point in nearly every case the government has brought and lost").

[6] *See, e.g.*, Chicago Bridge & Iron Co. v. FTC, 534 F.3d 410, 431 n.11 (5th Cir. 2008) ("Merger Guidelines are often used as persuasive authority when deciding if a particular acquisition violates anti-trust laws."); United States v. Kinder, 64 F.3d 757, 771 & n.22 (2d Cir. 1995) ("Although it is widely acknowledged that the Merger Guidelines do not bind the judiciary in determining whether to sanction a corporate merger or acquisition for anticompetitive effect . . . courts commonly cite them as a benchmark of legality."); Cal. v. Sutter Health Sys., 130 F. Supp. 2d 1109, 1120, 1128–32 (N.D. Cal. 2001) ("Although the Merger Guidelines are not binding, courts have often adopted the standards set forth in the Merger Guidelines in analyzing antitrust issues").

Merger Guidelines to the extent it finds them persuasive.[7] In practice, courts have relied heavily on prior versions of the Merger Guidelines, quickly adopting new analytic tools promoted therein.[8] The 1982 Guidelines had such an effect on antitrust jurisprudence that they have been described as "the most significant contribution by the federal agencies to non-criminal competition policy analysis in the modern era."[9]

Some commentators have suggested that this influence is a result of the relative lack of court precedent in the merger arena, particularly following the decline in litigated merger challenges after the adoption of the Hart-Scott-Rodino Antitrust Improvements Act in 1976.[10] Others have attributed the importance of the Merger Guidelines to the lack of Supreme Court precedent in the area in recent decades.[11] Still others have suggested the courts have made a policy choice to interpret case law as consistently as possible with enforcement agency practice.[12] Whatever the reason, the Merger Guidelines' effect on the courts has been substantial and has led some commentators to suggest that courts have been too deferential to the Merger Guidelines, granting them "precedent-like" treatment that is inappropriate for a statement of enforcement policy.[13]

*When the D.C. District Court next considered entry . . . it adopted wholesale the "timely, likely, and sufficient" framework of the 1992 Guidelines.*

In some cases, courts even seem to have given the Merger Guidelines more weight than their own precedent. In *United States v. Baker Hughes*, for example, the D.C. Circuit rejected an attempt by the Department of Justice to shift the burden to the defendant to show that entry would be "quick and effective" on the grounds that this "would require of defendants a degree of clairvoyance alien to section 7."[14] Following that decision, the Agencies adopted the 1992 Guidelines, which framed entry as a defense to the extent it is shown to be "timely, likely, and sufficient."[15] When the D.C. District Court next considered entry in *FTC v. Cardinal Health, Inc.*, it adopted wholesale the "timely, likely, and sufficient" framework of the 1992 Guidelines.[16]

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[7] *See, e.g.*, FTC v. H.J. Heinz Co., 246 F.3d 708, 716 n.9 (D.C. Cir. 2001) ("Although the Merger Guidelines are not binding on the court, they provide 'a useful illustration of the application of the HHI.'") (citation omitted); FTC v. Swedish Match, 131 F. Supp. 2d 151, 167 n.12 (D.D.C. 2000) ("The Merger Guidelines are not binding on the Court, but as this Circuit has stated, they do provide 'a useful illustration of the application of the HHI.'") (citation omitted).

[8] Courts have been similarly deferential in response to other revisions to the Guidelines. Courts were quick, for instance, to adopt HHI calculations of market concentration in the wake of the 1982 revisions, and to analyze efficiencies as described in the 1997 revisions. *See, e.g.*, FTC v. PPG Indus. Inc., 798 F.2d 1500, 1503 (D.C. Cir. 1986) (citing 1982 Merger Guidelines in adopting HHI as a measure of concentration), FTC v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997) (analyzing efficiencies under framework in 1997 revisions to the 1992 Merger Guidelines), United States v. Long Island Jewish Med. Ctr., 983 F. Supp. 121 (E.D.N.Y. 1997) (same).

[9] William E. Kovacic, *The Modern Evolution of U.S. Competition Policy Enforcement Norms*, 71 ANTITRUST L.J. 377, 435 (2003) (arguing that the 1982 Guidelines "changed the way the U.S. courts and enforcement agencies examine mergers").

[10] *See, e.g.*, Joe Sims & Deborah P. Herman, *The Effect of Twenty Years of Hart-Scott-Rodino on Merger Practice*, 65 ANTITRUST L.J. 865, 866 (1996) ("[S]ince HSR became effective in 1978, only about 22 percent of the mergers that have been formally challenged by the agencies have actually been litigated in district court—compared to about 50 percent in the decade preceding HSR.").

[11] Varney, Merger Guidelines Workshops, *supra* note 2, at 10 ("The lack of modern Supreme Court precedent also underscores the need for Horizontal Merger Guidelines that accurately reflect the best economic and legal reasoning.").

[12] Allis-Chalmers Mfg. Co. v White Consol. Indus., Inc., 414 F.2d 506, 523 (3d Cir. 1969).

[13] Hillary Greene, *Guideline Institutionalization: The Role of Merger Guidelines in Antitrust Discourse*, 48 WM. & MARY L. REV. 771, 835 (2006) ("For guidelines to gain a status akin to rules," as the Merger Guidelines have, "is inappropriate as a matter of law."); Louis B. Schwartz, *The New Merger Guidelines: Guide to Government Discretion and Private Counseling or Propaganda for Revision of the Antitrust Laws?*, 71 CAL. L. REV. 575, 576–77 (1983) (urging commentators to "continuously emphasize the nonbinding character of the Guidelines").

[14] 908 F.2d 981, 987 (D.C. Cir. 1990).

[15] 1992 Merger Guidelines, *supra* note 4, § 3.0.

[16] 12 F. Supp. 2d 34, 55 (D.D.C. 1998).

Persuading the courts to adopt the 2010 Guidelines' approach to market definition, however, is likely to be a more considerable challenge. The courts' long-standing treatment of market definition as a predicate to Section 7 claims is not a result of the 1992 Guidelines. In fact, in 1957—a decade prior to the adoption of the first set of Merger Guidelines—the Supreme Court in *United States v. E.I. du Pont de Nemours & Co.* described "[d]etermination of the relevant market" as "the necessary predicate" to a Section 7 claim.[17] And, in *Brown Shoe Co. v. United States*, the Supreme Court indicated that defining a market is required by the language of Section 7, which prohibits transactions that substantially lessen competition "in any line of commerce in any section of the country."[18]

In the half-century since *du Pont*, lower courts have continued to view market definition as a predicate to Section 7 claims. For example, the D.C. Circuit in *FTC v. Cardinal Health, Inc.* stated that "[d]efining the relevant market is the starting point for any merger analysis."[19] Similarly, the Eighth Circuit in *FTC v. Tenet Health Care Corp.* held that it is "essential that the FTC identify a credible relevant market before a preliminary injunction may properly issue" because "[w]ithout a well-defined relevant market, a merger's effect on competition cannot be evaluated."[20] And, just weeks before the final version of the 2010 Guidelines was published, the district court in *United States v. Dean Foods Co.* reaffirmed that "[i]n determining the likely anti-competitive effects of an acquisition, courts look to the relevant product market, as well as the relevant geographic market."[21]

Given the weight of this precedent, courts may be reluctant to embrace the 2010 Guidelines as readily as they have accepted past versions. Courts have, in other contexts, resisted adopting significant changes in agency guidance documents when the changes appeared to conflict with existing case law. In *United States v. Kinder*, for example, a prisoner defendant requested reconsideration of his sentencing for drug charges based on an amendment to the Sentencing Guidelines that changed the definition of how carrier weight would be calculated.[22] The Second Circuit rejected the request, finding that the Sentencing Guidelines amendment could not trump binding precedent that adopted the older method of carrier weight calculation. The dissent, in contrast, specifically pointed to the Merger Guidelines, and argued that with the Merger Guidelines courts had in fact altered prior precedent "by voluntarily accepting uncompelled guidance from a constructive administrative interpretation."[23]

Here, however, the existing court precedent does not simply adopt the treatment of market definition from an earlier version of the Merger Guidelines. Rather, the precedent is based on the language of the statute and predates the guidelines. It is not surprising, then, that judges have dismissed recent merger challenges that did not include a defined relevant market. For example, the Southern District of New York in *City of New York v. Group Health, Inc.* recently specifically rejected the plaintiff's attempt to use an alternative to a market definition screen.[24] The court dismissed the case on the grounds that the plaintiff's definition of the relevant market was inadequate as a

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17 353 U.S. 586, 593 (1957).

18 370 U.S. 294, 324 (1962).

19 12 F. Supp. 2d 34, 45 (D.D.C. 1998).

20 186 F.3d 1045, 1051 (8th Cir. 1999).

21 No. 10-CV-59, 2010 WL 1417926 at *1 (E.D. Wis. Apr. 7, 2010).

22 64 F.3d 757 (2d Cir. 1995).

23 *Id.* at 771–72.

24 No. 06 Civ. 13122 (RJS), 2010 WL 2132246 (S.D.N.Y. May 11, 2010).

*[T]he 2010 Guidelines ask more of the courts than previous versions have . . . courts may not be willing to forgo market definitions in Section 7 cases.*

matter of law, and rejected the plaintiff's attempt to amend the complaint to include evidence of anticompetitive effects based on an economic test emphasizing margins and diversion. The district court found no authority that might permit a case to go forward without a clear market definition and noted that "[i]n light of the case law's clear requirement that a plaintiff allege a particular product market in which competition will be impaired, this absence of authority is hardly surprising."[25]

Similarly, in August 2010, just after the announcement of the 2010 Guidelines, a district court rejected the FTC's post-acquisition challenge to Lundbeck Inc.'s purchase of a pharmaceutical treatment in development for patent ductus arteriosus.[26] The FTC had claimed that the acquisition enabled Lundbeck to raise the price of its earlier acquired treatment for the same condition by 1300%. Despite evidence of higher post-acquisition prices, and without mentioning the 2010 Guidelines, the court noted that market definition was a "necessary predicate" to a Section 7 claim and rejected the FTC's complaint on the grounds that the FTC had failed to demonstrate a relevant product market.[27]

It is possible that the courts may ultimately accept the 2010 Guidelines, as has been the case with past revisions to the Merger Guidelines. In fact, even prior to the 2010 Guidelines' release, there were indications that at least some courts might be receptive to a decreased emphasis on market definition. The split D.C. Circuit decision in *FTC v. Whole Foods Market, Inc.*, for instance, opens the door for the use of other economic tools in lieu of strict market definitions.[28] But the 2010 Guidelines ask more of the courts than previous versions have, and if recent court decisions are any indication, courts may not be willing to forgo market definitions in Section 7 cases. ●

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25 *Id.* at *6 n.6.

26 FTC v. Lundbeck, Inc., Civil No. 08-6379, slip. op., 2010 U.S. Dist. LEXIS 95365 (D. Minn. Aug. 31, 2010).

27 *Id.* at 38.

28 548 F.3d 1028 (D.C. Cir. 2008).

# 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.

*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.*

## 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.

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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-

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[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.

***[I]n the presence of substantial efficiencies, UPP may substantially overpredict a merger's likely effect on prices.***

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.

# 2010 Horizontal Merger Guidelines: The View from the Technology Industry

**Susan Creighton**

In 2005, MySpace's position as the leading social networking site appeared assured. It was gaining 70,000 new users every day,[1] and by 2006 it was the most visited Web site in the United States. Its 80 percent market share in social networking far outstripped its closest rival, Facebook, which remained a distant second at 10 percent.[2] In 2008, however, MySpace began to lose users to Facebook and then to Twitter. Its share in social networking dropped to 66 percent in 2008, and to 30 percent in 2009.[3]

According to a NewsCorp executive who had oversight for the MySpace business, the reason for this sharp drop was that MySpace stopped innovating at a time when it led in the market and had strong momentum, leaving the door open to its competitors. This executive stated: "The thing you see in this space more than anything else is that if you don't keep innovating and moving forward, you get in trouble. You can't stop [. . . .] And MySpace stopped."[4]

This lesson from MySpace—"if you don't keep innovating and moving forward, you get in trouble"—is, in my experience, the driving factor behind a majority of the mergers in the technology sector. Production efficiencies are rarely the motivation for high-tech mergers, because high-tech markets typically are characterized by large upfront fixed costs and low marginal costs of production.[5] Some high-tech mergers, of course, also are motivated by anticompetitive reasons. Most, however, are spurred by the need to innovate, as Joseph Schumpeter described long ago:

> [I]t is still competition within a rigid pattern of invariant conditions, methods of production and forms of industrial organization . . . that . . . monopolizes attention. But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization . . . competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives.[6]

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[1] Matthew Garrahan, *The Rise and Fall of MySpace*, FIN. TIMES, Dec. 4, 2009, *available at* http://www.ft.com/cms/s/2/fd9ffd9c-dee5-11de-adff-00144feab49a.html.

[2] Steve O'Hear, *Social Network Traffic up 11.5%; MySpace Still Dominates* (Mar. 15, 2007), *available at* http://www.zdnet.com/blog/social/social-network-traffic-up-115-percent-myspace-still-dominates/114.

[3] Garrahan, *supra* note 1.

[4] Juan Carlos Perez, *NewsCorp's Jon Miller: MySpace Stopped Innovating*, PC WORLD (Oct. 22, 2009) (quoting NewsCorp executive Jonathan Miller), *available at* http://www.pcworld.com/businesscenter/article/174181/news_corp_jon_miller_myspace_stopped_innovating.html.

[5] *See* Antitrust and the New Economy, Hearing before the Antitrust Modernization Commission (Nov. 17, 2005) (statement of George S. Cary), *available at* http://govinfo.library.unt.edu/amc/commission_hearings/pdf/Statement_Cary_final.pdf.

[6] JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 82–85 (Harper & Row 1975).

From the perspective of the technology sector, it is disappointing that the Agencies chose not to amend Section 10 of the 2010 Horizontal Merger Guidelines to reflect the importance of this dynamic innovation. Despite repeated calls to revise the 1992 Guidelines to give greater credence to dynamic efficiencies,[7] the Agencies have chosen to give greater weight to static efficiencies, and to the modest gains that they enable, than to the dynamic efficiencies that are the principal source of sweeping productivity gains.[8]

The reason the Agencies give for this policy preference is that static efficiencies are more certain and easier to verify. Thus, they declare in the 2010 Guidelines that efficiencies "resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the incremental cost of production," are "more likely to be susceptible verification and are less likely to result from anticompetitive reductions in output."[9] Dynamic efficiencies, by comparison, "are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions."[10]

***A merger policy that ignores potential dynamic efficiencies . . . can harm consumers far more than even significant price increases.***

It is true, of course, that Schumpeterian competition to provide "the new commodity, the new technology, the new source of supply" is inherently uncertain. Such leapfrogging innovation, however, is crucial to long-term gains to consumer welfare. Indeed, it is generally accepted that small increases in productivity from innovation can dwarf the effects of static efficiency over time.[11] A merger policy that ignores potential dynamic efficiencies therefore can harm consumers far more than even significant price increases.

Moreover, from a high-tech perspective, the 2010 Guidelines include errors of commission as well as omission. Most notable in this respect is the new Section 2.2.3, where the Agencies indicate that they will consider the views of competitive rivals "especially in cases where the Agencies are concerned that the merged entity may engage in exclusionary conduct."[12] The Guidelines contain the following example:

> *Example 2:* Merging Firms A and B operate in a market in which network effects are significant, implying that any firm's product is significantly more valuable if it commands a large market share or if it is interconnected with others that in aggregate command such a share. Prior to the merger, they and their rivals voluntarily interconnect with one another. The merger would create an entity with a large enough share that a strategy of ending voluntary interconnection would have a dangerous probability of creating monopoly power in this market. The interests of rivals and consumers would be broadly aligned in preventing such a merger.

The Agencies do not indicate that they would require evidence that the parties themselves contemplated such a strategy post-merger, or previously had engaged in similar conduct in compa-

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[7] *See, e.g.*, ANTITRUST MODERNIZATION COMM'N, REPORT AND RECOMMENDATIONS 40 (2007) ("To improve the application of antitrust in new economy industries, antitrust enforcers should give further consideration to efficiencies that lead to more rapid or enhanced innovation. The potential benefits to consumer welfare from such efficiencies are great, thus warranting careful assessments of the potential for certain business conduct to create more rapid or enhanced innovation"), *available at* http://govinfo.library.unt.edu/amc/report_recommendation/chapter1.pdf.

[8] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines 29–31 (2010) [hereinafter 2010 Guidelines], *available at* http://ftc.gov/os/2010/08/100819hmg.pdf.

[9] *Id.* at 31.

[10] *Id.*

[11] *See, e.g.*, *Antitrust and the New Economy, Hearing before the Antitrust Modernization Commission* 5 (Nov. 8, 2005) (statement of M. Howard Morse), *available at* http://www.ftc.gov/os/comments/horizontalmergerguides/545095-00044.pdf.

[12] 2010 Guidelines, *supra* note 8, at 6.

rable circumstances. In view of the high market shares that characterize many high-tech markets, and structural characteristics (such as network effects) that often are present in these markets, the Agencies appear to be opening the door to potent game-playing by rivals.[13]

The Agencies' approach in Example 2 contrasts strikingly with their expressed skepticism about dynamic efficiencies. On the one hand, the Agencies tell merging parties who base their investment decisions on the prospect of potential dynamic efficiencies that, even though "projected reasonably and in good faith," their expected gains will be heavily discounted because they "may not be realized."[14] On the other hand, the Agencies have expressed no similar caution in Example 2 about their ability to estimate the likelihood of potential anticompetitive effects. In the high-tech sector at least, however, such modesty is particularly warranted. A competitor complaining to the Agencies about MySpace in 2007 or 2008, for example, could have pointed to network effects, user lock-in, first-mover effects, and high persistent market shares to argue that MySpace had market power. Such complaints might have seemed compelling. Only a year later, however, MySpace's position in the market was collapsing.

*The Agencies' failure to amend Section 10 is most important from a high-tech perspective, and the addition of Example 2 perhaps the most alarming,*

The Agencies' failure to amend Section 10 is most important from a high-tech perspective, and the addition of Example 2 perhaps the most alarming, the Agencies did make some advances in the Guidelines' analysis of long-term supply constraints. This change is helpful because, in many procompetitive high-tech mergers, long-term supply considerations are the principal competitive restraint on the parties. Under the 1992 Guidelines, the Agencies considered only demand-side factors in their market definition, and limited market participants to those who could enter within one year (and, in entry analysis, those who could enter within two years). Moreover, as a practical matter, Agency staff often tended to give these supply considerations slight attention, despite their significant real-world effects.

Under the 2010 Guidelines, the Agencies now clearly state that supply-side responses are an integral part of their competitive effects analysis.[15] In addition, the Agencies have replaced the one-year standard for assessing new entry with a more flexible assessment, considering the likelihood of "rapid" entrants who will enter "in the near future." They also have eliminated the two-year window on assessing the timeliness of entry.[16] Work remains to be done, however, because the Agencies continue to focus exclusively on the demand side in market definition, with the result that

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[13] It is instructive to compare Example 2 with the Federal Trade Commission's review a few years ago of the acquisition of Adelphia by Comcast. In that case, the Commission considered whether increased concentration of market shares in several regional cable markets would give Comcast the incentive to engage in exclusionary conduct (the use of exclusive contracts to tie up essential programming). The Commission found that, in other markets where Comcast had similar shares, it did not engage in such anticompetitive conduct:

> But we do need facts that show that it is likely that the transactions would lessen competition in a relevant market. "Natural experiments," i.e., evidence that the posited harm has occurred under circumstances similar to the proposed transactions, are relevant to merger analysis. Consequently, the Bureaus carefully reviewed the evidence of prior conduct by the parties in markets such as Chicago and Sacramento. . . . The evidence concerning the conduct in these other markets did not indicate that the proposed transactions under review here are likely to reduce competition in any relevant geographic market.

Statement of Chairman Majoras, Commissioner Kovacic, and Commissioner Rosch Concerning the Closing of the Investigation into Transactions Involving Comcast, Time Warner Cable, and Adelphia Communications, FTC File No. 051-0151 (Jan. 31, 2006), *available at* http://www.ftc.gov/os/closings/ftc/0510151twadelphiamajoras_kovacic_rosch.pdf.

[14] 2010 Guidelines, *supra* note 8, at 30.

[15] *See id.* at 7 ("The responsive actions of suppliers are also important in competitive analysis. They are considered in these Guidelines in the sections addressing the identification of market participants, the measurement of market shares, the analysis of competitive effects, and entry").

[16] *Id.* at 28–29.

a disproportionately large percentage of high-tech mergers still fit poorly within the Agencies' articulated framework.

Where, then, are we with respect to the evaluation of high-tech mergers under the 2010 Guidelines? High-tech mergers, as noted earlier, are likely to include participants with deceptively high market shares (because the Agencies' view is static, not dynamic). The Agencies remain likely to give insufficient weight to long-term supply constraints. Finally, because the role of innovation continues to be inadequately considered (the mergers achieve "only" dynamic efficiencies), high-tech mergers remain potentially vulnerable to attack as anticompetitive based on structural market characteristics (such as network effects).

We are thus still far away from a merger framework that, in Schumpeter's words, captures "capitalist reality as distinguished from its textbook picture." The Agencies' decision not to amend Section 10, and the addition of new Section 2.2.3, suggest a deliberate policy decision to give undue weight to the benefits of enforcement, and too little weight to the costs of excessive deterrence. This policy preference calls to mind the implicit policy decision of the Federal Circuit during the 1980s and 1990s, that, because patents reward innovation, facilitating the issuance of more patents must also be good for innovation. In truth, antitrust enforcement is good, but more antitrust enforcement is not better. Chilling procompetitive mergers that have the potential for leapfrogging innovation can and will do very great harm to consumer welfare, and I hope that we will see further improvements in future Guidelines to rectify these apparent shortcomings. ●

# The 2010 Horizontal Merger Guidelines: A Static Compass in a Dynamic World?

Jay Ezrielev and Janusz A. Ordover

The 2010 U.S Department of Justice and Federal Trade Commission Horizontal Merger Guidelines[1] are finally here, and we commend the authors for making significant improvements to the 1992 Guidelines in a variety of areas.[2] The 2010 Guidelines more closely reflect the Agencies' current practices and provide the merging parties a plethora of detail regarding methodologies used in merger review. The 2010 Guidelines also introduce important new analytical tools to aid in the assessment of likely competitive effects. These tools build on, and effectively exploit, the implications of first-order conditions for profit maximization in static oligopoly models. In our view, however, the 2010 Guidelines fall short in better integrating the dynamic aspects of competition into merger assessment. As the matter stands now, "dynamic" competition analysis appears to be an afterthought to the more traditional approach. In this note, we suggest a few areas where dynamic analysis is likely to be especially valuable in better aligning the workings of markets with conclusions on merger effects.

The term "dynamic competition" is generally used in two different ways. First, commentators often apply the term to markets that experience significant change in their underlying structural conditions such as rapid decline, growth, or technological progress. Markets in which competition is driven by innovation naturally fall into this category. In such markets, the standard static tools of merger assessment are generally inadequate for the task at hand. The new section in the 2010 Guidelines on innovation and product variety addresses the unilateral effects from a merger on competition in innovation-intensive markets.[3] This section is a significant step forward in analysis of mergers in innovation-intensive markets. However, the section does not sufficiently reflect the notion that in innovation-intensive markets, the current market positions of the merging firms (and their rivals) are often a poor proxy for future competitiveness.

In this essay, we use the term dynamic competition in a second sense, namely as a shorthand for the link between firms' current actions and future profits stemming from strategic decisions aimed at maximizing the expected net present value of current and future profits. These types of dynamic considerations underlie Section 2 cases and are important for analyzing competitive effects in industries where intertemporal dynamics are relevant to the full assessment of merger effects.[4] These types of dynamic considerations enter into the analysis of pricing, output, investment, entry, exit, and product repositioning decisions.

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

[2] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (1992, rev. 1997) [hereinafter 1992 Guidelines], *available at* http://www.justice.gov/atr/public/guidelines/hmg.pdf.

[3] 2010 Guidelines, *supra* note 1, § 6.4.

[4] For example, dynamic considerations are central to *Brooke Group*'s recoupment test. *See* Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

Despite the significant advances in analyzing dynamic models of competition,[5] the core methodology for reviewing mergers under the 2010 Guidelines relies heavily on the static "workhorses" of industrial organization economics, namely the oligopoly models of Cournot and Bertrand.[6] We acknowledge that the 2010 Guidelines address various issues that pertain to dynamic competition, as did the 1992 Guidelines.[7] However, the 2010 Guidelines continue to regard dynamic competition considerations not as core elements of merger review but rather as either evidence that may be used to rebut the presumptions created by the various static filters or as a source of additional competitive concern.

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This point can be illustrated by the analysis of unilateral effects from mergers in differentiated products industries. The 2010 Guidelines' merger review in such industries is based on a notion that a merger of two (close) rivals creates static upward pricing pressure (UPP) that potentially may be countered by savings in marginal costs flowing from the transaction.[8] However, the UPP method builds on premerger profit-maximization conditions, and as such, it inevitably ignores potential responses by non-merging firms and the feedback from these anticipated responses on the behavior of the merging firms. Under the 2010 Guidelines, the inferences from the UPP method (or static merger simulations) may be rebutted by considering dynamic aspects of competition such as entry and repositioning. Because the 2010 Guidelines' core method for analyzing mergers in differentiated products markets (and also in homogeneous products markets) is based on a static framework, this creates the risk that dynamic considerations will be relegated to an afterthought, especially in view of how difficult it can be (in practice) to rebut the presumption of harm and to develop and quantify evidence on dynamic effects.

Moreover, the 2010 Guidelines make extensive use of inferences from the Lerner condition—another workhorse of industrial organization economics—which relates a product's short-term margin to its short-term elasticity of demand. However, in dynamic settings (and in other settings, such as markets with multi-sided platforms), the link between this elasticity and margins may not be consistent with the standard Lerner condition. In particular, in such dynamic settings, applying the Lerner condition to current margins may lead to incorrect inferences about demand elasticity and UPP measures.

It is our view that dynamic competition analysis should be a core part of the merger screening process (i.e., before the Agencies' findings of rebuttable presumptions). Below we sketch out how dynamic competition models can be more effectively incorporated into basic merger analysis. We focus on the 2010 Guidelines' treatment of non-merging firms' response and margins—areas in which dynamic competition models may be particularly relevant.

## Responses of Non-Merging Firms

Under the 2010 Guidelines, the Agencies consider two potential types of responses by non-merging firms in assessing whether the responses would be sufficient to "deter or counteract any

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[5] *See* Liran Einav & Jonathan D. Levin, *Empirical Industrial Organization: A Progress Report*, 24 J. ECON. PERSP., Spring 2010, at 145.

[6] *See* DENNIS W. CARLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 160–76 (4th ed. 2005).

[7] For example, both the 1992 and the 2010 Guidelines include a section on entry. 1992 Guidelines, *supra* note 2, § 3; 2010 Guidelines, *supra* note 1, § 9.

[8] 2010 Guidelines, *supra* note 1, § 6.1.

competitive effects of concern."[9] The two types of responses are: (1) entry,[10] and (2) repositioning, in the case of differentiated products markets.[11] For entry, the 2010 Guidelines largely follow the 1992 Guidelines in focusing on whether entry would be "timely, likely, and sufficient in its magnitude, character, and scope to deter or counteract the competitive effects of concern."[12] A similar standard applies to repositioning.[13]

To assess whether entry would be timely, likely, and sufficient, the Agencies consider a number of factors, including evidence of actual history of entry into the relevant market, sunk costs associated with entry, output levels that the entrant is likely to obtain, likely post-entry price levels, per unit costs that the entrant is likely to incur, whether the market values of firms in the industry exceed the replacement cost of capital, whether there are reputational barriers or other impediments that the entrant would face, and whether the entrant's scale and strength exceeds that of one of the merging firms.[14] However, the 2010 Guidelines do not provide clear guidance on how to ascertain whether the presence or absence of these factors is sufficient to deter or counteract the competitive effects of concern or how these factors can be traded off against each other. Such absence of clear guidance can lead to significant uncertainty for the merging parties.

Moreover, many of the factors the 2010 Guidelines consider in entry analysis could be further developed and placed in a context of a comprehensive dynamic model. For example, the 2010 Guidelines state that the "sufficiency" requirement for entry would be satisfied if a single firm's entry "will replicate at least the scale and strength of one of the merging firms."[15] But given that mergers do not typically discard *all* of the assets of one of the merging firms, replacing all of the scale and strength of one of the merging firms is likely unnecessary to counteract the competitive effects of concern.

In addition, what matters for entry analysis is not necessarily whether post-merger entry would be likely and timely but whether the increase in the likelihood of or advance in the timing of entry in response to a post-merger price increase (or reduction in quality) would be sufficient to deter such price increases (or reductions in quality). Since the 1992 Guidelines were issued, there has been significant progress in the economic modeling of entry.[16] However, this progress is not reflected in the 2010 Guidelines. Perhaps a more effective approach to entry analysis would be to incorporate entry into a dynamic model of competition (data permitting) and to estimate the

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9 *Id.* § 9.

10 *Id.* Although the 2010 Guidelines discuss output expansion by non-merging firms, the discussion is largely confined to calculating market shares and focuses on output expansion using existing capacity rather than on developing new capacity in response to a merger. *See, e.g.*, *id.* § 5.2.

11 *Id.* § 6.1.

12 *Id.* § 9.

13 *Id.* § 6.1. Although the 2010 Guidelines devote an entire section to entry, there is very little discussion about product repositioning. In particular, the 2010 Guidelines do not explain what repositioning entails in actual markets or describe the economic analyses that the Agencies would perform to assess whether repositioning would be timely, likely, and sufficient. As product repositioning can significantly alter the effects of a merger on competition, the Agencies should pay significant attention to this type of competitive response by non-merging firms and clarify their approach. *See, e.g.*, Amit Gandhi, Luke Froeb, Steven Tschantz & Gregory J. Werden, *Post-Merger Product Repositioning*, 56 J. Indus. Econ. 49 (2008).

14 2010 Guidelines, *supra* note 1, § 9.

15 *Id.* § 9.

16 *See, e.g.*, Patrick Bajari, C. Lanier Benkard, & Jonathan Levin, *Estimating Dynamic Models of Imperfect Competition*, 75 Econometrica 1331 (2007).

merger effects directly (including the effect of the merger on the likelihood of entry and its consequent effect on competition).

The 2010 Guidelines' analysis of non-merging firms' responses appears to focus on large-scale entry. However, effective response by non-merging firms may take variety of forms, such as building or expanding existing manufacturing facilities, introducing new products and services, expanding sales teams, opening new sales office locations, launching new marketing campaigns, intensifying research and development efforts, using new distribution channels, or establishing new partnerships with other firms.[17] These strategies may be undertaken in conjunction with aggressive pricing and other incentives to win customers from the merging parities. Even if such responses by non-merging firms are modest in scale for each individual firm, in aggregate, these responses may provide potent deterrents against any potential reduction in competition. Thus, responses by incumbent non-merging firms are potentially important features of dynamic competition that are insufficiently reflected in the 2010 Guidelines.

A natural question about such post-merger responses is why these strategies would only be profitable post-merger. One reason is that mergers may confer benefits not only on the merging parties but also on the non-merging firms. The post-merger competitive landscape can create new opportunities for non-merging firms. For example, non-merging firms may be in a position to acquire assets shed by the merging parties at a relatively low cost; may be able to hire experienced staff formerly employed by the merging parties without paying a premium; or more readily pursue merging parties' customers. Such customers may be more likely to switch suppliers because of service disruptions resulting from merger integration or because of a close relationship with a sales representative no longer employed by the merging parties.

Moreover, opportunities for the non-merging firms would be further amplified if the merging parties raised prices or reduced services. Importantly, non-merging firms also may receive a "closer look" from some customers post merger. In a bidding context, it is common for customers to consider closely only a few competing bids.[18] Thus, a customer who, premerger, considered competing bids from the merging parties will now be willing to (or will have to) consider a bid from a non-merging firm or firms. This effectively reduces marketing costs for the non-merging firms and improves exposure to customers with the concomitant benefits to dynamic competition.

## Margins

Merging parties' premerger margins play a central role in merger review under the 2010 Guidelines. The Agencies use margins in a number of analyses, including: (1) market definition; (2) the UPP method for screening for unilateral price effects in differentiated products markets; and (3) assessing the likelihood of a "unilateral output suppression strategy" in "markets involving relatively undifferentiated products."[19] However, the Agencies' use of margins, as described in the 2010 Guidelines, appears to be flawed in certain respects. Consider the following statement in the market definition section of the 2010 Guidelines: "Unless the firms are engaging in coordinated interaction (see Section 7), high pre-merger margins normally indicate that each firm's product

[17] In declining industries, a non-merging firm response may take the form of retaining assets that would have exited but for the output reduction (or price increases) by the merging firms. In this case, retaining assets that would have exited otherwise has the same effect as entry but without the associated sunk costs of entry.

[18] Full assessment of bids is costly for customers, but customers need to consider two competing bids for the purposes of benchmarking and negotiations.

[19] 2010 Guidelines, *supra* note 1, §§ 4.1.3, 6.1, 6.3.

individually faces demand that is not highly sensitive to price. Higher pre-merger margins thus indicate a smaller predicted loss as well as a smaller critical loss."[20]

The statement regarding the relationship between margin and elasticity follows from the Lerner condition, which is a static equilibrium condition. However, the standard Lerner condition is unlikely to be satisfied under many real-world market circumstances, including markets with network or consumer externalities, markets for exhaustible resources, innovation markets, markets undergoing significant change in underlying structural parameters, markets in which suppliers face learning curve effects, two-sided markets, markets in which participants engage in limit pricing, markets with lagged demand responses to price changes, and numerous other market scenarios.[21] In these cases the static optimization conditions will not generally hold because of intertemporal dependency among prices, demand, production costs, entry, and investment decisions. In real-world market settings, firms make business decisions that satisfy dynamic optimization conditions, i.e., firms take into account the effect of current period actions on expected future period profits. In addition, as the 2010 Guidelines recognize, the standard Lerner condition will not generally be satisfied in those market settings where firms engage in some degree of coordinated interaction. Thus, because firms in actual market settings do not generally set prices based on static optimization, inferring demand elasticity from static margins (as the 2010 Guidelines appear to do) can lead to wrong inferences regarding the likely effects of a transaction.[22]

***[I]n recent years there has been significant progress in the analysis of dynamic models.***

## Dynamic Models of Competition

One of the drawbacks of dynamic models is that these models are often characterized by multiple equilibria.[23] Because standard economic analysis assesses merger effects based on comparison of pre- and post-merger equilibria, the possibility of multiple post-merger market outcomes poses a special challenge to such analyses. The multiplicity of equilibria in dynamic models makes these models problematic for predicting merger outcomes. This is likely a major reason why the Agencies have not fully embraced dynamic models in merger review.

However, in recent years there has been significant progress in the analysis of dynamic models. One promising approach is to model dynamic competition under the assumption that firms deploy so-called Markov strategies, whereby each firm's strategy is a function of the current (observable) state of the industry.[24] This "simplification" imposes sufficient structure to provide a practical framework to forecast competition outcomes (without running into a multiplicity of equilibria problem) and at the same time retain key features of competition in an industry. Although these models impose significant data and computational demands on estimation and forecasting procedures, the model assumptions may be chosen to strike the right balance between, on the one

[20] *Id.* § 4.1.3 (citation omitted). Section 7 of the 2010 Guidelines indicates that "coordinated interaction" involves conduct by multiple firms that results in prices that exceed the benchmark static equilibrium prices.

[21] *See* Robert S. Pindyck, *The Measurement of Monopoly Power in Dynamic Markets*, 28 J.L. ECON. 193, 193–95 (1985).

[22] According to the 2010 Guidelines, "the profit margin on incremental units is the difference between price and incremental cost on those units." 2010 Guidelines, *supra* note 1, § 4.1.3. Such margins do not accurately reflect the full economic benefits of sales because they do not account for the effects of sales on future demand and costs, for example.

[23] It is common in industrial organization literature to analyze dynamic models as repeated plays of static games. However, there are other more general formulations of dynamic models.

[24] *See, e.g.*, Bajari, Benkard, & Levin, *supra* note 16; C. Lanier Benkard, *A Dynamic Analysis of the Market for Wide-Bodied Commercial Aircraft*, 71 REV. ECON. STUD. 581 (2004); Richard Ericson & Ariel Pakes, *Markov-Perfect Industry Dynamics: A Framework for Empirical Work*, 62 REV. ECON. STUD. 53 (1995).

hand, practical application and, on the other hand, accurately capturing the relevant competitive forces in the industry.[25]

## Conclusion

The merger review process would benefit from additional integration of dynamic competition analysis into the Agencies' basic merger review methodologies. Dynamic competition models are generally applicable for merger analysis in all types of markets. However, merger analysis using dynamic competition models is particularly important for markets with significant intertemporal dependencies among prices, demand, production costs, entry, and investment decisions, i.e., markets for which static optimization conditions generally do not adequately reflect the full range of business considerations that motivate firms' decisions, including the decisions of the merging firms and their current and likely future rivals. Economics has made significant progress in analyzing dynamic competition models over the past decade and, thus, we anticipate that these new tools will be embraced by the Agencies before the next overhaul. ●

[25] Note that static models strike this balance in favor of practical application but at the expense of capturing relevant aspects of competition.

# The Revised Merger Guidelines:
# Did the Agencies Heed the Lessons of the Past?

**Deborah L. Feinstein**

In the Fall 2009 issue of *Antitrust* magazine, I offered some views on issues the Agencies should consider in issuing new merger guidelines.[1] It is too early to assess to what degree the revisions addressed those considerations. The real test of how well the new 2010 Horizontal Merger Guidelines[2] will work will be seen in their implementation over time in individual cases. Nevertheless, I offer some preliminary views on the extent to which the Agencies addressed issues important to consider in promulgating new Guidelines.

***Consider the Purpose of the 2010 Guidelines.*** The key purpose of the Guidelines is to provide practitioners and businesses with a view as to how the Agencies approach merger analysis. The 2010 Guidelines set forth several areas of departure from the 1992 Horizontal Merger Guidelines[3] and made clear how the Agencies intend to conduct their analysis. For instance, the 2010 Guidelines establish that:

- Market definition is no longer the requisite starting point for merger analysis;
- Where direct evidence of competitive effects is available, the Agencies will rely less on market definition in their analysis;
- "Critical loss" analysis may inform market definition;
- Geographic market definition considers the locations of both customers and suppliers; and
- Diversion ratios and merger simulation models, including use of the "upward pricing pressure" test, are tools the Agencies will use in analyzing the level of competition between differentiated products.

These are all concepts the Agencies have discussed for some time. They were, in many cases, foreshadowed by the Commentary on the 1992 Horizontal Merger Guidelines.[4] While there are areas of ambiguity and areas where there could be further clarity, the 2010 Guidelines cannot address the specifics of every merger investigation, which is by its nature fact-specific. The Guidelines also set forth some of the types of evidence and tools the Agencies use in conducting their analysis. In both of these ways, the 2010 Guidelines appear to have accomplished their goal of informing practitioners and the business community how their investigations are conducted.

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[1] Deborah L. Feinstein, *Enforcement Changes: Evolution or Revolution?*, ANTITRUST, Fall 2009, at 5.

[2] 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.

[3] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (1992, rev. 1997) [hereinafter 1992 Guidelines], *available at* http://www.justice.gov/atr/public/guidelines/hmg.htm.

[4] U.S. Dep't of Justice & Fed. Trade Comm'n, Commentary on the 1992 Horizontal Merger Guidelines (2006), *available at* http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf.

The 2010 Guidelines can also help guide the courts on the Agencies' views as to the proper manner in which to analyze mergers. At times, this purpose can be in tension with the goal of providing guidance to parties as to how the Agencies will investigate mergers internally. In their effort to give the courts a roadmap, the Agencies may take more stark positions than they otherwise would in conducting their investigation. In some respects, the initial draft of the 2010 Guidelines suffered from that shortcoming. However, a number of more extreme positions were toned down in the revisions after public comment. For instance,

- The final Guidelines no longer refer to evidence of a high purchase price as evidence that the acquiring firm expects to be able to reduce competition. Instead, acknowledging that a premium may be justified by synergies and efficiencies, the 2010 Guidelines note that "a purchase price *in excess of the acquired firm's stand-alone market value* may indicate that the acquiring firm is paying a premium because it expects to be able to reduce competition *or to achieve efficiencies*."[5]
- The final version adds the notion that when the value of diverted sales is proportionately small, significant unilateral price effects are unlikely.[6]
- With respect to whether a merger may enhance the vulnerability of a market to coordinated conduct, the Guidelines make clear that rather than "a theory they deem plausible"—the language in the initial proposed Guidelines—the Agencies must have a "credible basis on which to conclude" that coordinated conduct might occur.[7]

While the substance of the 2010 Guidelines may make it easier to bring a challenge in court, their rhetoric and language appear less devised than the initial draft of the 2010 Guidelines to create a one-sided document for use in court challenges.

***Consider What Worked Well in the 1992 Guidelines.*** A noteworthy aspect of the 1992 Guidelines is how long they endured, despite introducing a number of new concepts. In many respects, the 2010 Guidelines have maintained the basic structure of the 1992 Guidelines. The key analytical pieces—market definition, concentration, anticompetitive effects, entry, and efficiencies—remain in place. Yet within that framework, the Agencies have introduced new methods of conducting that analysis. Standing alone, the notion that the Agencies will use various economic tools, such as the "upward pricing pressure" (UPP) model, does not necessarily mean that the 2010 Guidelines will become obsolete as new economic tools develop and as additional thinking is done with respect to the economic tests in the Guidelines. There is a risk, however, that in practice, concepts like the UPP will become talismans, rather than one piece of evidence, and as such will be given inordinate importance. In that event, if new economic thought supersedes those concepts, the 2010 Guidelines may become obsolete far earlier than they should.

*In many respects, the 2010 Guidelines have maintained the basic structure of the 1992 Guidelines. The key analytical pieces—market definition, concentration, anticompetitive effects, entry, and efficiencies—remain in place.*

***Consider What Did Not Work Well in the 1992 Guidelines and Base the Revisions on the Agencies' Experience.*** The criticisms of the 1992 Guidelines arising from the efforts to create bright lines and retain unfounded presumptions have been somewhat ameliorated by the 2010 Guidelines. The 2010 Guidelines have taken an important step forward in eliminating what was an arbitrary and baseless presumption that in certain circumstances in which the merging companies' combined share was 35 percent "the Agency would presume that a significant share of sales

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5 2010 Guidelines, *supra* note 2, § 2.2.1 (emphasis added).

6 *Id.* § 6.1.

7 *Id.* § 7.1.

in the market are accounted for by consumers who regard the products of the merging firms as their first and second choices."[8]

The HHI thresholds have been increased to capture fewer transactions, but they still do not reflect the Agencies' experience over the years. For the most part, the HHIs in the 2010 Guidelines continue to be lower than the level at which most challenges typically take place. From FY 1998 through FY 2007, in industries other than chemicals, pharmaceuticals, oil, and supermarkets, the Federal Trade Commission brought a challenge in only one market out of 64 in which the post-merger HHI was under 2400.[9] This challenge involved a delta HHI far greater than the 100 points at which the revised Guidelines state that potentially significant competitive concerns can be raised in moderately concentrated markets (between 1500 and 2500).[10] Indeed, for the majority of markets in which the post-merger HHI was between 2400 and 2999 the FTC did not bring a challenge, even when the HHI change was above 100 points. Notably, not a single challenge occurred where the delta HHI was under 200, although the 2010 Guidelines hold to the notion that such mergers in highly concentrated markets "potentially raise significant competitive concerns and often warrant scrutiny."[11]

***Make the Guidelines Practical.*** Whether the 2010 Guidelines are practical will depend on how they are implemented in practice. For example, the UPP model is not intuitive to business people, nor particularly easy to implement as an initial screen. If it becomes a necessary initial step involving a data-intensive, months-long process for every transaction that raises unilateral effects concerns, the 2010 Guidelines will not have offered practical guidance. Similarly, if the Agencies rarely challenge transactions within the new moderately concentrated range of the HHI, they risk unduly deterring transactions that raise no significant issues.

***Consider the Relationship Between Substantive Analysis and the Review Process.*** The increased use of electronic communication has vastly increased the amount of documents and data available, and more sophisticated economic tools require more extensive data. There is significant risk that by identifying various economic tools that can be used, staff will feel compelled to employ them more often than is necessary, with attendant production burdens. Rather than requesting focused data that get at the heart of the matter, second requests too often contain broad specifications requesting all documents and data for a variety of topics and are not quickly and appropriately narrowed to the key issues. This can increase the burden substantially on parties and, in some cases, prevent parties from being able to complete their deals. For a small company, the costs of complying with a complex and detailed CID or second request may not be justified by the size of the transaction or the companies at issue.

It is one thing if there is information that is critically important to analyzing the substance of the case. Yet, there are still many aspects of the second request process that go beyond what is reasonably necessary to get to the core of an issue. To point to one example: Many second requests have a specification that requires a detailed description of—and the provision of—every database the companies use. Both as written and in the cumbersome negotiations that follow, this specification does not provide the Agencies with the information they really need. Often this request does

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[8] 1992 Guidelines, *supra* note 3, § 2.211.

[9] Fed. Trade Comm'n, Horizontal Merger Investigation Data, Fiscal Years 1996–2007, Table 3.6 (Dec. 1, 2008), *available at* http://www.ftc.gov/os/2008/12/081201hsrmergerdata.pdf.

[10] The Horizuntal Merger Investigation Data lump together mergers with HHI concentration levels between 2400 and 2999 so it is not possible to examine the data only for what the Guidelines now consider moderately concentrated markets post-merger.

[11] 2010 Guidelines, *supra* note 2, § 5.3.

*With the new Guidelines' increased focus on data, there is considerable potential that overly broad requests not only remain, but become more difficult to discuss in a practical way with staff.*

not efficiently obtain relevant information and instead imposes undue burden and time delays on the parties. Too much back and forth is spent on technical characteristics of the database rather than figuring out what information the companies have, whether the Agencies need it, and how they might obtain it. With the new Guidelines' increased focus on data, there is considerable potential that overly broad requests not only remain, but become more difficult to discuss in a practical way with staff.

### Consider the Need for Greater Transparency.

The Agencies continue to issue statements or other guidance, not only in matters where they have accepted settlements, which is quite routine, but also in closed investigations.[12] That practice is expected to continue under the 2010 Guidelines. Some of the statements have been quite detailed. Others have left open more questions. For instance, in the United Airlines/Continental matter, the Division explained its concern that the combination would lead to a high share of service in Newark, New Jersey.[13] It did not, however, explain why it did not require a consent decree to cover the transfer of slots at Newark to Southwest. Was this part of the Division's long-standing practice to accept "fix-it-first" solutions or simply an isolated acceptance of such a solution? More information on these sorts of issues is always welcome.

### Don't Let the Perfect Be the Enemy of the Good.

There are welcome aspects of the revised Guidelines—elimination of unnecessary presumptions and discussions of the types of evidence the Agencies analyze—and also areas where experience is needed before judgments can be made. But the Agencies set out to provide revised guidance and did so quickly and with considerable clarity. Only time will tell whether they met their mark. ●

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[12] *See, e.g.*, Press Release, U.S. Dep't of Justice, Justice Department Will Not Challenge Cisco's Acquisition of Tandberg (Mar. 29, 2010), *available at* http://www.justice.gov/atr/public/press_releases/2010/257173.htm; Statement of the Commission Concerning Google/AdMob, FTC File No. 101-0031 (May 21, 2010), *available at* http://www.ftc.gov/opa/2010/05/ggladmob.shtm.

[13] Press Release, U.S. Dep't of Justice, United Airlines and Continental Airlines Transfer Assets to Southwest Airlines in Response to Department of Justice's Antitrust Concerns (Aug. 27, 2010), *available at* http://www.justice.gov/atr/public/press_releases/2010/262002.htm.

# Market Definition, the New Horizontal Merger Guidelines, And the Long March Away from Structural Presumptions

**Deborah A. Garza**

Most merger analysis is a predictive exercise. The enforcement agencies and courts use their best efforts to predict whether a proposed merger will on balance harm consumers through the elimination of competition.

The role of market shares and concentration in that predictive exercise has changed over time. Antitrust has evolved from a world in which the enforcement agencies accorded primary significance to the market shares of the merging firms to one in which market shares play only a minor or supporting role or, in some cases perhaps, no role in determining the agencies' enforcement decision. The new Horizontal Merger Guidelines make clear that today market shares are considered merely "in conjunction with" other evidence to predict the likely effect of a merger, and are not used as an actual "screen" to separate competitively benign mergers from those that may be or are likely to be anticompetitive.[1]

In the "old days," predictions were based on a fairly simple assumption about the effect of concentration on competition—that is, that fewer firms and higher concentration likely leads to less competition. The Department of Justice's Merger Guidelines issued in 1968 stated that the "primary role" of merger enforcement was thus "to preserve and promote market structures conducive to competition."[2] The 1968 Guidelines explained:

> [N]ot only does emphasis on market structure generally produce economic predictions that are fully adequate for the purposes of a statute that requires only a showing that the effect of a merger "may be substantially to lessen competition, or to tend to create a monopoly," but an enforcement policy emphasizing a limited number of structural factors also facilitates both enforcement decision-making and business planning which involves anticipation of the Department's enforcement intent.[3]

Back at that time, the agencies and courts relied on four-firm market concentration ratios to predict a merger's likely effect. According to the 1968 Guidelines, the DOJ would ordinarily challenge a merger resulting in the four largest firms controlling 75 percent or more of the market if (for example) the acquiring firm had a four percent share and the acquired firm's share was four percent or more.[4] If the four-firm concentration ratio (CR4) was less than 75, the DOJ would ordinarily challenge a merger where the acquiring firm had a five percent share and the acquired firm's share was five percent or more.[5] In other words, in a "highly concentrated" market (as defined by the

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*Ms. Garza thanks Covington & Burling associate Jesse Gurman for his assistance with this essay.*

[1] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 5.3 (2010) [hereinafter 2010 Guidelines], *available at* http://ftc.gov/os/2010/08/100819hmg.pdf.

[2] U.S. Dep't of Justice, Merger Guidelines § 2 (1968) [hereinafter 1968 Guidelines], *available at* http://www.justice.gov/atr/hmerger/11247.pdf.

[3] *Id.* § 2.

[4] *Id.* § 5.

[5] *Id.* § 6.

1968 Guidelines), a merger could not result in the merged firm controlling as much as eight percent of the relevant market. Even in any "less highly concentrated market,"[6] no merger could result in a single firm controlling more than 10 percent of the market.[7] These market share limits were based on court decisions reflecting legislative intent to shelter smaller businesses and stop a perceived so-called rising tide of concentration, rather than on sound empirical evidence demonstrating actual effects on competition at such levels of concentration.[8]

By the time of the 1982 Guidelines, merger analysis had become more refined, but retained a structural presumption. The CR4 was replaced by the Herfindahl-Hirschman Index (HHI), which better predicted a merger's impact on concentration by considering all firms in the market and taking account of their relative size.[9] Under the 1982 Guidelines, a merger resulting in an HHI of 1000 or less (imagine at least ten equally-sized firms)—corresponding to a CR4 of 50 or less—was considered to be immune from challenge. A merger resulting in an HHI between 1000 and 1800, with an increase of 100 or more, was "more likely than not"[10] to be challenged, unless other factors, such as ease of entry or efficiencies indicated otherwise. And a merger resulting in an HHI of 1800 or greater (imagine about six or fewer equally-sized firms)—corresponding to a CR4 of 70 or more—with an increase in the HHI of 100 points or more was "likely" to be challenged.[11] Thus, a merger resulting in a CR4 of 70 between a 10-percent firm and a five-percent firm was presumptively subject to challenge.

*The 1968 and 1982 Guidelines solved the prediction problem by establishing relatively straight-forward structural presumptions that could be applied with (seemingly) relative ease.*

The 1982 Guidelines thereby established a clear "safe harbor" that was lacking in the 1968 Guidelines and set the bar of presumptive challenge higher, but not shockingly so. By the terms of the 1982 Guidelines, moreover, it would be difficult to prove other factors (including efficiencies) sufficiently to overcome the presumption of anticompetitive effects. The 1982 Guidelines explained the connection between concentration and the exercise of market power: first, a single firm with a larger share of supply is more likely to be able profitably to raise price by unilaterally restricting its own output (i.e., to exercise market power); second, collective action is more plausible where fewer firms control a substantial percentage of total supply.[12]

The 1968 and 1982 Guidelines solved the prediction problem by establishing relatively straightforward structural presumptions that could be applied with (seemingly) relative ease. They provided a reasonable degree of certainty for businesses, though the empirical basis for the prediction was shaky. The 1968 and 1982 Guidelines also put a premium on market definition. Because of the significance of market shares and concentration-based presumptions, the fight in court, as well as before the agencies, often turned on how the relevant markets were defined.

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6 *Id.*

7 The DOJ could have challenged mergers below even these thresholds in industries experiencing a trend toward concentration over the prior five to ten years. *See id.* § 7.

8 *See, e.g.*, United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963). See also Oliver Williamson, The Merger Guidelines of the U.S. Department of Justice—In Perspective, Remarks at the 20th Anniversary of the 1982 Merger Guidelines (June 10, 2002), *available at* http://www.justice.gov/atr/hmerger/11257.htm, for a brief discussion of work on the "structure, conduct, performance (SCP) approach."

9 *See* U.S. Dep't of Justice, Merger Guidelines § III.A (1982), *available at* http://www.justice.gov/atr/hmerger/11248.pdf.

10 *Id.* § III.A.1.

11 *Id.* The 1982 Guidelines also created a presumption against any merger that would increase the share of a firm holding 35 percent of the market by more than one percent.

12 *Id.* § III.A; *see also* U.S. Dep't of Justice, Merger Guidelines § 3.10 (1984) [hereinafter 1984 Guidelines], *available at* http://www.justice.gov/atr/hmerger/11249.pdf.

Almost as soon as the 1982 Guidelines were released, however, they were revised to respond to concerns that overly rigid application of the HHI thresholds could erroneously prohibit mergers that, in particular, would enable U.S. based firms to compete more effectively in world markets (at the time concern centered on more efficient Japanese firms). The business community desired a more nuanced analysis, albeit at the necessary expense of certainty.

*A primary goal of the 1992 Guidelines was to further de-emphasize the importance of the HHIs in favor of an analysis that focused on the "story" of competitive effects—that is, the specific theory of competitive harm.*

Thus started the long march away from structural presumptions and the importance of defining markets to where we are today. The 1982 Guidelines were revised in 1984 to soften the structural presumption. For example, a statement was added that "market share and concentration provide only the starting point for analyzing the competitive impact of a merger."[13] The DOJ would expressly consider "all other relevant factors that pertain to" a merger's likely effect on competition.[14] Nevertheless, the 1984 Guidelines also provided that the DOJ would "focus first" on market concentration in any investigation.

A primary goal of the 1992 Guidelines was to further de-emphasize the importance of the HHIs in favor of an analysis that focused on the "story" of competitive effects—that is, the specific theory of competitive harm. The 1992 Guidelines also emphasized so-called unilateral effects analysis as a theory of harm separate from coordinated effects, focused on the ability of the merged firm to unilaterally raise the price of its product.[15] Nevertheless, the 1992 Guidelines continued to state that the enforcement agencies' first step would be to assess whether the merger would significantly increase concentration. They retained the same HHI standards established in the 1982 Guidelines, removed the language of presumption from the 1000–1800 range, but continued to warn of a presumption of illegality for mergers in the 1800/100+ range. Although the presumption could be overcome, the 1992 Guidelines continued to be tough on the evidence needed to prove countervailing factors, placing an arguably disproportionate burden on merging firms to prove efficiencies and entry.

So what happened between 1992 and 2010? For one thing, the 1992 Guidelines became significantly out of synch with actual agency practice. It was clear based on the enforcement record that mergers at or somewhat above the 1800/100 range were *not* presumptively subject to challenge (at least not outside the world of grocery stores and retail gasoline mergers where, for political reasons, the relevant threshold was even lower).[16] For most mergers to draw a challenge, particularly outside of these two industries, the post-merger HHI had to be at least 2400/200 or higher, and the bulk of challenges targeted HHIs substantially higher than these thresholds.[17] The apparent discrepancy between the guidelines and actual practice discouraged at least one court

[13] 1984 Guidelines, *supra* note 12, § 3.11. The 1984 Merger Guidelines also softened the presumption language, changing "more likely than not" to "likely" and removed the statement that close cases would be resolved against the merging parties.

[14] *Id.*

[15] Dennis Carlton has explained the dichotomy between unilateral and coordinated effects in the 1992 Merger Guidelines is somewhat confused and probably confusing to businesses as well as the courts. *See, e.g.*, Dennis W. Carlton, Comment on Department of Justice and Federal Trade Commission's Proposed Horizontal Merger Guidelines § II.D (June 4, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00034.pdf.

[16] *See* Fed. Trade Comm'n, Horizontal Merger Investigation Data, Fiscal Years 1996–2007 tbls. 3.1–3.6 (2008), *available at* http://www.ftc.gov/os/2008/12/081201hsrmergerdata.pdf.

[17] *See id.*

[18] *See* FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109, 129 (D.D.C. 2004) ("[T]his case is not one in which the post-merger increase in HHI produces an overwhelming statistical case for the likely creation or enhancement of anticompetitive market power. . . . Indeed between 1999 and 2003, only twenty-six merger challenges out of 1,263 (two percent) occurred in markets with comparable concentration levels to those argued here.").

from condemning a merger based on HHI thresholds.[18] It also led the Antitrust Modernization Commission (AMC) to recommend that the 1992 Guidelines be updated.

In fact, except in court pleadings, the agencies simply no longer relied much on market concentration as a general screen. According to a former head of the Federal Trade Commission Bureau of Competition, under her watch, staff recommendations to challenge a merger rarely even mentioned relevant markets, much less HHIs, at least until it was time to draft a complaint.[19] Instead, the enforcers had come increasingly to rely on unilateral effects stories and direct evidence of likely price effects where it was available, such as studies comparing prices where the merging companies competed and did not and merger simulation models.

But because the 1992 Guidelines talked in terms of markets and market concentration, courts have generally assessed mergers that way,[20] and the agencies were beginning to lose cases in court due to skepticism about seemingly overly narrow, even gerrymandered, markets.[21] The agencies faced three unhappy choices: to litigate a case that is different from the one they investigated; to convince the courts that it is unnecessary to define a market (despite precedent and contrary to what the agencies' own Guidelines said); or, to convince the courts to accept narrow markets, possibly comprising only the merging parties and/or small groups of customers.[22] This dilemma is what led to revising the 1992 Guidelines.[23]

***The 2010 Guidelines arguably have moved as far away from market structure presumptions as possible given the state of the law.***

The 2010 Guidelines arguably have moved as far away from market structure presumptions as possible given the state of the law. They abandon the analytical framework of prior guidelines in favor of describing principal analytical techniques and types of evidence used to assess a merger and make plain that the agencies' analysis need not start with nor even necessarily use market definition. They explain that market shares are often one "useful indicator of likely competitive effects."[24]

The 2010 Guidelines also substantially increase the HHI thresholds to more closely reflect enforcement reality. The 1000 HHI safe harbor has become 1500 and the 1800 threshold has become more than 2500 (imagine four equally sized firms, instead of six). The highly concentrated presumption has been retained where the post-merger HHI increases by more than 200 (rather than 100) points, though the presumption is subject to rebuttal by "persuasive evidence" that the merger would not likely enhance market power.[25]

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19 *See* Fed. Trade Comm'n, Transcript of Unilateral Effects Analysis and Litigation Workshop 184–87 (Feb. 12, 2008) (testimony of Susan Creighton) [hereinafter FTC Workshop], *available at* http://www.ftc.gov/bc/unilateral/transcript.pdf; *see also* Evanston Northwestern Healthcare Corp., FTC Docket No. 9315, at 54 (Aug. 6, 2007) ("Although the courts discuss merger analysis as a step-by-step process, the steps are, in reality, interrelated factors, each designed to enable the fact-finder to determine whether a transaction is likely to create or enhance existing market power."), *available at* http://www.ftc.gov/os/adjpro/d9315/070806opinion.pdf.

20 *But see* FTC Workshop, *supra* note 19, at 167–70 (testimony of Judges Diane Wood and Douglas Ginsburg); United States v. Baker Hughes Inc., 908 F.2d 981, 984 (D.C. Cir. 1990) ("Evidence of market concentration simply provides a convenient starting point for a broader inquiry into future competitiveness.").

21 *See* Creighton testimony, *supra* note 19, at 184–89.

22 *See id.*; *see also* FTC v. Whole Foods Mkt., Inc., 502 F. Supp. 2d 1 (D.D.C. 2007); United States v. Oracle, 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

23 *Cf.* U.S. Dep't of Justice & Fed. Trade Comm'n, Commentary on the Horizontal Merger Guidelines (2006), *available at* http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf.

24 2010 Guidelines, *supra* note 2, §§ 5, 5.3.

25 *Id.* § 5.3. The agencies may also measure market concentration using the number of "significant competitors."

The 2010 Guidelines thus better reflect how the agencies actually assess mergers.[26] But they are no panacea. In the first instance, by throwing out the structural screens of the older guidelines, the new guidelines may also substantially erode the predictability of enforcement decision-making and, thus, certainty for business planning "which involves anticipation of the Department's enforcement intent."[27]

Second, it is unclear how well the agencies will fare in preliminary injunction hearings without relying on some sort of market share screen. Although the 2010 Guidelines contain a rebuttable 2500/200+ presumption, the very efforts the agencies have made to diminish the significance of market shares and concentration should make it more difficult to rely on them in court, and, indeed, there is no apparent empirical basis establishing their predictive reliability in general or with respect to specific industries. It may thus remain a challenge for the government to put on its entire competitive effects case. Moreover, because in any enforcement action, the agencies will "normally identify one or more relevant markets," they may continue to face a significant challenge in proving credible-sounding relevant markets in many unilateral effects cases.

Third, the upward pricing pressure (UPP) indices and margin-based analysis with which the agencies apparently intend to effectively replace HHIs in cases alleging unilateral effects (effectively, most cases) have their own significant difficulties. The UPP is untested as a merger screen. As others have noted, there is no empirical analysis supporting its predictive value in assessing mergers.[28] There are also both practical and conceptual limits to its application, which are beyond the scope of this essay but extremely important.[29] Ultimately, what we most need to support sound merger enforcement are further study of the economic foundations of merger policy (including the relationship between concentration and other market characteristics and market performance) and retrospective study of past merger enforcement decisions, which had been called for by the AMC to provide a better basis for consensus and for assessing the efficacy of current enforcement policy.[30] ●

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26 Even the higher thresholds may be somewhat misleading based on the agencies' own statistics. See Carlton, *supra* note 15, § II.A.

27 *See* 1968 Guidelines, *supra* note 2, § 2 (quoted *supra* p. 1).

28 *See* Carlton, *supra* note 14, § III, ¶ 27.

29 *See generally id.* § III; Malcolm B. Coate & Joseph J. Simons, *Critical Loss vs. Diversion Analysis: Clearing up the Confusion*, Competition Pol'y Int'l (Antitrust Chronicle No. 1, Dec. 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1562006.

30 *See* Antitrust Modernization Comm'n, Report and Recommendations 10 (2007) (recommendation 10), *available at* http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf.

# Are the New Guidelines Representational Art Or Pop Art in the End?

Ilene Knable Gotts

The 2010 Merger Guidelines, following in the tradition of previous Guidelines, seek to provide a representational portrait of the analytical underpinnings of current enforcement policy.[1] Such transparency is indisputably a sound objective; the agencies should be applauded for undertaking this project so that those who do not practice before the agencies on a routine basis are not misled by the existence of out-of-date Guidelines. As discussed further below, however, certain features described in the Guidelines would have benefited from more refined focus and insight rather than broad impressionistic strokes. Moreover, as with pop art, to the extent that the 2010 Guidelines contain untested methods of identifying competitive harm or deviate from established case precedent, the 2010 Guidelines run the potential of becoming out of date as these theories are later modified or rejected. Failing to reflect the case law from which the agencies derive their enforcement power, particularly as it relates to the importance of market definition, inferences from market shares, and the importance of noneconomic evidence, is perhaps too avant-garde an exercise for merger guidelines.

The original 1968 Guidelines explained where, as a matter of prosecutorial discretion, the Agencies would *not* challenge a transaction.[2] The new Guidelines similarly provide this guidance in a few new areas, for instance in footnote 14, where they recognize that consumer welfare might be better served by the agencies taking into account out-of-market efficiencies that outweigh potential harm to the delineated market and are inextricably linked to the merger. It would have been useful if the 2010 Guidelines had included more indications of where the agencies would not take action, for instance, with respect to repositioning, entry, and high margin industries. Two other areas where the 2010 Guidelines would have benefited from a more detailed explanation are the discussion of non-price effects, such as quality and variety, in Section 1; and the reduction in product "variety" and innovation concerns raised in Section 6.4.

As with earlier versions of the Guidelines, the 2010 Guidelines also discuss what information would be useful to present to the agencies. Again, such transparency is right in line with what guidelines are supposed to do. The 2010 Guidelines would have benefited as well by providing more guidance on how the agencies will weigh the various types of information they obtain rather than merely providing a comprehensive checklist.

Issuing the new Guidelines is a major step, and there is a considerable downside to including less-tried theories and methodologies or deviating substantially from established principles of law and economics. Concepts embraced in the new Guidelines but not yet widely accepted by the antitrust community or courts include the use of the upward pricing pressure model (including its

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*Mrs. Gotts thanks Ramsey Shehadeh for his useful input.*

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

[2] U.S. Dep't of Justice, Merger Guidelines (1968), *available at* http://www.justice.gov/atr/hmerger/11247.pdf.

dismissal of diversion ratios to products sold by non-merging firms) for differentiated products and the use of high margins to create presumptions of lack of demand responses, narrow markets, and market power.[3] As stated in the Verizon et al. submission, "the tools included in the Guidelines' toolbox must be based on consistently and unquestionably reliable methodologies that identify anticompetitive mergers. Such tools are those that are backed by a broad consensus, by empirical research, and by the test of time."[4]

Developing trends are better reflected in speeches and papers than in guidelines; they can then be discussed and, if needed, dismissed, as thinking evolves. Moreover, the 2010 Guidelines state that they are intended to "assist the courts in developing an appropriate framework for interpreting and applying the antitrust laws in the horizontal merger context."[5] It is precisely because courts (and foreign jurisdictions) might rely on the 2010 Guidelines, as they have with prior guidelines, that it is potentially harmful to include unproven economic theories or methodologies.

*It is precisely because courts (and foreign jurisdictions) might rely on the 2010 Guidelines, as they have with prior guidelines, that it is potentially harmful to include unproven economic theories or methodologies.*

There is a clear distinction between having guidelines that reflect best-in-class tools and thinking in analyzing mergers but remain true to the law and legal principles, and those that raise less developed or accepted economic or legal principles. Like its predecessors, the 2010 Guidelines are not the law, but rather a reflection of enforcement policy. Section 7 of the Clayton Act is several decades old and has a well-established body of case law. If, as some commentators suggest, the 2010 Guidelines are intended to provide the underlying framework for an improvement in the agencies' track record when bringing merger challenges, then enforcement policy (and the Guidelines) would benefit from responding to the messages that the courts have been sending, rather than trying to change the approach that the courts take. A major concern with the 2010 Guidelines, therefore, is the extent to which they deviate from the law, which could decrease—rather than increase—the agencies' litigation success rate. I discuss a few examples below.

One area where the 2010 Guidelines deviate from the law is the apparent shifting of the burden of proof based upon the margins of the transaction parties. Section 2.2.1 appears to shift to the parties the burden of establishing that any pricing above some measure of cost does not result from market power or coordination.[6] Commissioner J. Thomas Rosch properly noted that higher margins can result from circumstances apart from anticompetitive conduct, such as exogenous factors or the type of industry involved.[7] For instance, in technology markets, higher profit margins can be a direct consequence of effective and robust competition, as firms successfully differentiate and out-innovate competitors in response to customer demand. Moreover, such "rewards" may be fleeting as other firms respond and reposition. A healthy marketplace requires that firms

[3] For a discussion of some of the issues with the economic screens and tests, see Dennis W. Carlton, Comment on Department of Justice and Federal Trade Commission's Proposed Horizontal Merger Guidelines (June 4, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00034.pdf; Joseph J. Simons, Comments to the Federal Trade Commission and Department of Justice Antitrust Division: Margins in Merger Analysis (June 4, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00019.pdf. These topics would be better discussed outside of the Merger Guidelines.

[4] Joint Submission of Verizon Communications Inc., The Biotechnology Industry Organization, The Financial Services Roundtable, Microsoft Corporation, The National Association of Manufacturers, and the U.S. Chamber of Commerce to the U.S. Department of Justice and Federal Trade Commission for the Horizontal Merger Guidelines Revision Project at 1 (June 4, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00022.pdf.

[5] 2010 Guidelines, *supra* note 1, § 1.

[6] This language was somewhat improved from the April draft of the Guidelines, which suggested that high margins *ipso facto* resulted from market power or coordination.

[7] Statement of Commissioner J. Thomas Rosch on the Release of the 2010 Horizontal Merger Guidelines (Aug. 19, 2010), *available at* http://ftc.gov/os/2010/08/100819hmgrosch.pdf.

be permitted to recoup their upfront investments as well as to be compensated for the risks that result from failed endeavors. Similarly, the assertion that a high purchase price may indicate that the acquiring firm is paying a premium to reduce competition is inappropriate.[8] Particularly in industries with high fixed costs and sunk investment, a firm may pay a premium for many pro-competitive (or competitively neutral) reasons, such as synergies or better access to financing.

*Clayton Section 7 has a “substantial” element to it, and the agencies would be remiss not to look at the impact of the merger from a total consumer welfare standard rather than from gerrymandered markets delineated narrowly around complaining customers.*

In another departure from the case law, the 2010 Guidelines appear to relax the requirement of delineating a cognizable relevant market in which the transaction may have a substantial effect on competition. Since at least *duPont*, determination of a relevant market has been a “necessary predicate” to a Clayton Section 7 claim.[9] The statute itself requires a lessening of competition in a line of commerce. While courts have incorporated information beyond market shares into the consideration of whether the transaction will harm competition since at least *General Dynamics*, the 2010 Guidelines appear to go much further by relaxing and potentially omitting the need to delineate a cognizable relevant market.[10] Yet, in spite of these changes, the new Guidelines maintain presumptions of illegality (albeit “rebuttable”) based on market shares and concentration in markets that are narrowly defined to eliminate “more distant” competitors or to include a subset of “target” customers.[11] Such presumptions of illegality not only raise the likelihood of false positives, but ultimately of more agency losses in court.

Sections 3 and 6.1 of the 2010 Guidelines deviate from the law by permitting challenges based on a single or a few injured parties—the so-called “targeted customers.” It is inevitable that for some mergers there are some unhappy or even adversely impacted customers. Clayton Section 7 has a “substantial” element to it, and the agencies would be remiss not to look at the impact of the merger from a total consumer welfare standard rather than from gerrymandered markets delineated narrowly around complaining customers. The analysis should include recognition that inframarginal customers may complain even though they will not actually be harmed, perhaps because they fail to recognize that they will be protected by the existence of marginal customers. The approach taken in these sections is likely to raise evidentiary issues in satisfying the substantiality element of the statute.

The entry discussion also contains some elements that depart from case precedent, such as *Baker Hughes*.[12] Although the new Guidelines clarify that the parties need not prove that entry would be at the scale and strength of one of the merging firms,[13] the continued inclusion of this benchmark in the Guidelines remains troubling and departs from case precedent. As some respected economists point out,[14] this standard may require a demonstration that post-merger price will be below pre-merger levels rather than merely sufficient to replace the lost output. The objective should be maintaining—not improving upon—the competitive status quo ante.

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[8] 2010 Guidelines, *supra* note 1, § 2.2.1.

[9] United States v. E.I. du Pont de Nemours & Co., 353 U.S. 586, 593 (1957); Brown Shoe Co. v. United States, 370 U.S. 294, 324 (1962).

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

[11] *Id.* § 4.1.4. Further, the identification of “safe harbors” has been removed from the Guidelines.

[12] United States v. Baker Hughes Inc., 908 F.2d 981 (D.C. Cir. 1990).

[13] 2010 Guidelines, *supra* note 1, § 9.3 (“Entry by a single firm that will replicate at least the scale and strength of one of the merging firms is sufficient. Entry by one or more firms operating at a smaller scale may be sufficient if such firms are not at a significant competitive disadvantage.”).

[14] Elizabeth M. Bailey, Gregory K. Leonard & Lawrence Wu, Comments on the 2010 Proposed Horizontal Merger Guidelines (June 3, 2010), http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00012.pdf.

The slant towards economic formulae and theories, particularly concerning the implications of margins and incremental costs also raises concerns given recent jurisprudence. As Commissioner Rosch indicates:

> [C]ourts have relied on empirical evidence instead of economic evidence, and have considered economic evidence as corroborative of that empirical evidence, if they have considered it at all. . . . Time and again, appellate courts have rejected “high” prices as a basis for inferring market or monopoly power. The district courts have likewise eschewed reliance on economic models based on margins for a variety of reasons, including their complexity, because margins are dependent on exogenous factors, or because the use of such economic simulation models, in the absence of substantial, verified efficiencies, will almost always predict a transaction will have price effects.[15]

Courts will review the entire evidentiary record—documents, data, and testimony—rather than allowing economic models and theories alone to win the day.

Finally, the modifications of the SSNIP test based on value-added profit calculations[16] could result in false positives because the set of competitors will be artificially narrowed and exclude competitive constraints on prices. For example, applying a 5 percent value added SSNIP test to the mark-up on a retail item may yield a SSNIP threshold on the final product of less than a penny in some cases. Also, this calculation is likely to raise evidentiary problems for both the government and the parties, as well as miss what should be the focus—i.e., whether there will be an impact on the price or output of the products and services actually bought by consumers.[17] The relevant product or service is what the consumer buys and at what price—not what each supplier might add to the product and at what profit to the supplier for that particular input to the finished product.

In sum, the agencies are to be commended for replacing the outdated Guidelines with a more accurate description of the types of evidence and analysis they are currently deploying. The 2010 Guidelines, though, fall a little short of the mark as a complete representational work of art in not providing a robust discussion for the business community regarding certain of the newer aspects of the 2010 Guidelines, how the various features will be balanced, and when a transaction will not be challenged by the agencies. Moreover, the new Guidelines suffer to the extent that they deviate from well-established principles, particularly in determining market definition and, ultimately, competitive harm. Pop art has its place in merger analysis—but the Merger Guidelines are not the best place for its debut. ●

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15 Rosch Statement, *supra* note 7 (citations omitted).

16 Although the 2010 Guidelines removed the reference to “specific contribution of value,” example 10 remains.

17 Bailey et al. Comments, *supra* note 14.

# A Return to *Von's Grocery*?

John D. Harkrider

In 1966, the Supreme Court held in *United States v. Von's Grocery Co.*[1] that a merger between Von's Grocery Company and Shopping Bag Food Stores, which created a firm with a combined market share of just under 8 percent, violated Section 7 of the Clayton Act.[2] After a firestorm of criticism from the business community that no merger between competitors was safe from challenge,[3] the 1968 Horizontal Merger Guidelines for the first time set forth a number of bright-line statistical thresholds for merger enforcement, including a provision that the government was unlikely to challenge a merger where the combined share of the merging parties was under 8 percent.[4]

Since 1968, the many revisions to the Merger Guidelines reflect two general trends. First, the revisions in 1982, 1992, and 2010 substantially reduced the number of mergers subject to challenge on the theory of coordinated effects. The revisions achieved this by increasing the thresholds necessary for coordinated effects and by setting forth the market conditions necessary for coordinated effects to take place. These revisions reflect the empirical evidence that many markets are not susceptible to coordinated effects and those that are require higher concentration levels than previously thought.

Second, the revisions in 1992 and 2010 expanded the number of mergers subject to unilateral effects analysis. Indeed, the 2010 Merger Guidelines eliminated every statistical threshold used to determine whether unilateral effects would plausibly result from a merger. The elimination of such thresholds (however flawed)—and the failure to replace them with other, more prudent limits—is particularly troubling because it is almost impossible to test the plausibility of unilateral effects in any empirical manner. In this way, the newest iteration of the Merger Guidelines potentially returns us to the days of *Von's Grocery*, when businesses are unable to determine with any degree of certainty whether particular mergers are likely to be challenged by the Government.

## Trends in Coordinated Effects

To see how much the Herfindahl-Hirschman Index (HHI) thresholds have increased over the years, it is helpful to review the HHI thresholds that the Government and businesses have used to identify mergers likely to be challenged under each iteration of the Merger Guidelines. As shown in Figure 1, the definition of "highly concentrated" has increased from as low as 1400 in the 1968 Guidelines to 2500 in the 2010 Guidelines, with the delta necessary for a presumption of anti-

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1 384 U.S. 270 (1966).

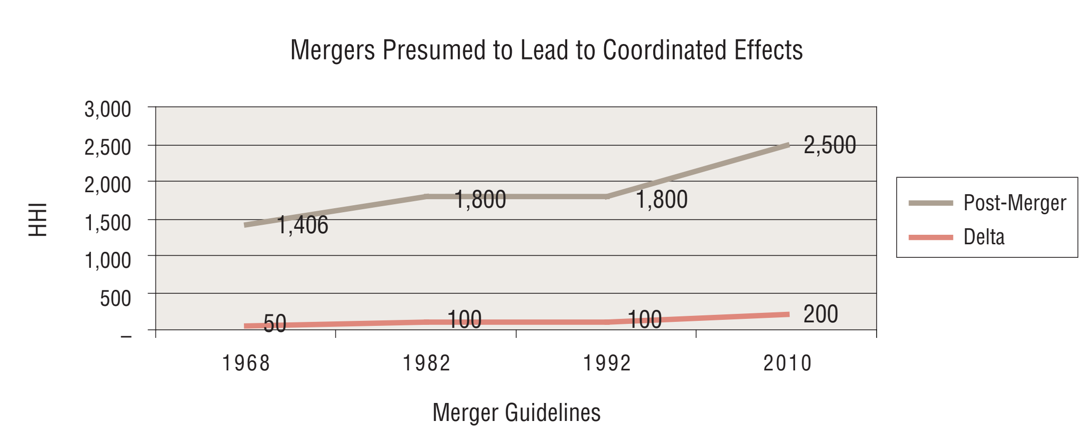
2 *Id.* at 272, 277.

3 For example, Justice Stewart complained that the sole consistency in Section 7 litigation was that "the Government always wins." *Id.* at 301 (Stewart, J., dissenting). *See also* RICHARD A. POSNER, ANTITRUST LAW 105–09 (1976).

4 U.S. Dep't of Justice, 1968 Merger Guidelines § I.5, at 6, *available at* http://www.justice.gov/atr/hmerger/11247.pdf.

competitive effects in highly concentrated markets increasing from as low as 30 points in 1968[5] to 200 points in 2010.[6]

**Figure 1**




This increase in the statistical thresholds reflects the view that coordinated effects are only likely to occur at very high statistical thresholds and only where certain market conditions are met. Importantly, this conclusion is subject to empirical testing. For example, in many mergers (and industries), there is significant variation in concentration across time and geographic markets. One can then test whether higher concentration levels in one market lead to higher profits or prices than in markets with lower concentration levels. If this empirical examination does not reveal differences in competition as a result of higher concentration levels in the past, it is difficult to predict reliably an increase in the future.

## Unilateral Effects

The 1992 Guidelines introduced the concept of unilateral effects to merger enforcement. Because unilateral effects analysis depends upon switching, survey, or scanner data that are frequently hard for the merging parties to acquire, it is difficult to come up with easy-to-understand statistical metrics that can signal to the business community which transactions are likely to trigger an investigation or enforcement action. The 1992 Guidelines attempted to resolve this problem by introducing two statistical thresholds: first, that unilateral effects were unlikely where the post-merger HHI was lower than 1800;[7] and second, that the government would presume that a significant number of consumers regarded the products of the merging parties as their first and second choices if the parties' combined market share was over 35 percent.[8]

5 The 1968 Guidelines stated that markets where the four largest firms in the industry had a combined market share of more than 75 percent were "highly concentrated" and that the Department would "ordinarily" challenge a transaction in highly concentrated markets where the acquiring and acquired firm had market shares of at least 4 percent. *Id.* § I.5 at 6. Assuming an equal distribution of market shares, the lowest HHI that would correspond to a CR4 of 75 percent would be approximately 1400. The lowest delta arising from a combination of firms with a share of at least 4 percent would be approximately 30 points. For transactions falling below the 75 percent (or 1400) threshold, the 1968 Guidelines stated that the transaction must result in a delta of roughly 50 points.

6 U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 5.3, at 19 (Aug. 19, 2010) [hereinafter 2010 Guidelines], *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf.

7 U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 1.51, at 16 (1992, rev. 1997), *available at* http://www.justice.gov/atr/public/guidelines/hmg.pdf.

8 *Id.* § 2.211, at 23–24.

The 2010 Guidelines eliminate these statistical thresholds, in large part because the concept of "market" does not necessarily make sense in the context of unilateral effects. In their place, the 2010 Guidelines cite to the usefulness of diversion ratios, upward pricing pressure (UPP), and merger simulation.[9] Lost in the haze of coefficients and confidence intervals is the somewhat troubling fact that the sine qua non of unilateral effects—the ability of firms to reposition in the event of a unilateral exercise of market power by the merged firm—is almost completely unsusceptible to empirical examination. At best, one might test what happens when one of the two merging firms is unavailable for a given bidding contest, but such a test does not necessarily replicate the profit opportunities presented by the permanent unavailability of a competing firm as a result of a merger.

Perhaps more significantly, evidence as to the likelihood of repositioning is in the hands of competitors who have every incentive in the world to downplay their ability to reposition, especially in mergers that would allow the merged firm to lower price or improve quality. An extreme example of this occured in 1999 and 2000 when the Regional Bell Operating Companies (RBOCs) filed thousands of pages with regulators in opposition to the merger of the near-bankrupt and since-acquired WorldCom and Sprint, claiming that the RBOCs would be unable to compete in the tightly controlled "oligopoly" of long distance telephony that the ROBCs now dominate.[10]

Indeed, taken to the extreme, the 2010 Guidelines could support the conclusion that unilateral effects are possible even where the post-merger HHI is under 1000 and the combined market shares are under 8 percent. For example, Malcolm Coate and Joseph Simons argue that UPP analysis "could essentially condemn" a merger between "six equally situated pre-merger entities with margins as low as 30 [percent]."[11] In other words, the 2010 Guidelines would permit a challenge to a merger with market shares similar to those found in *Von's Grocery*, provided there was evidence that a significant number of customers regarded the merging firms as their first and second choices (which was absent in *Von's Grocery*)[12] and testimony of rivals that they could not replace the competition previously provided by one of these two firms.

## The Importance of Caution

There are many reasons to caution against Government involvement in the economy. It is difficult for regulators to predict the future and the process of such prediction is so time consuming and expensive that only those firms that are likely to obtain supracompetitive returns from a particular regulatory outcome are likely to participate in the process.[13] Trends in antitrust jurisprudence over the last forty years reflect judicial awareness of this problem. Specifically, in the context of Section 2 of the Sherman Act, courts have construed the antitrust laws to permit both the possession of

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[9] 2010 Guidelines, *supra* note 6, § 6.1, at 21.

[10] Comments, *In re* Applications of Sprint Corp. Transferor, and MCI WorldCom, Inc., Transferee, for Consent to Transfer Control of Corporations Holding Commission Licenses and Authorizations Pursuant to Sections 214 and 310(d) of the Communications Act and Parts 1, 21, 24, 25, 63, 73, 78, 90, and 101, CC Docket No. 99-333 (FCC 2000); Opposition of SBC Commc'n, Inc., *Id.*

[11] Joseph J. Simons & Malcolm B. Coate, Upward Pressure on Price (UPP) Analysis: Issues and Implications for Merger Policy 17 (Working Paper, July 8, 2010), *available at* http://ssrn.com/abstract=1558547.

[12] *Von's Grocery* departs from the 2010 Guidelines on this ground as "Von's stores were located in the southern and western portions of the Los Angeles metropolitan area, and . . . Shopping Bag stores were located in the northern and eastern portions." 384 U.S. 270, 295 (1966) (Stewart, J., dissenting).

[13] *See, e.g.*, E.C. Pasour, Jr., *Economists and Public Policy: Chicago Political Economy Versus Conventional Views*, 74 PUBLIC CHOICE 153, 155 (1992), *available at* http://www.jstor.org/stable/30025594 (subscription required).

market power and the extraction of monopoly rents in the form of reduced output or higher prices by firms with market power.[14] In the context of Section 1, courts have narrowed the antitrust laws to permit the inference of an agreement only where there is evidence that tends to exclude the possibility of unilateral behavior,[15] and, even then, only when the agreement has actually resulted in anticompetitive effects or is likely to result in the unilateral exercise of market power within a properly defined relevant market.[16] And in the context of coordinated effects under Section 7, both courts and agencies have reduced the number of mergers that are likely to be challenged by raising statistical thresholds and setting forth specific requirements for coordinated effects to occur.[17]

*[W]hile the 2010 Guidelines provide transparency into the process that the government uses to evaluate mergers, they fail to fulfill another important function of Merger Guidelines, which is to let merging parties know ex ante whether a merger is likely to be challenged so they can accurately size and price the antitrust risk.*

The evolution of unilateral effects, however, represents just the opposite trend. Not only have the agencies eliminated market share statistical thresholds, but they have dispensed with the requirements of market definition altogether. What is more, they have expanded on a theory of competitive effects predicated on a prediction of the ability of rivals to reposition—a determination that is not only rarely susceptible to empirical proof but also depends critically on evidence from competitors who have every incentive to oppose procompetitive mergers or force the parties to dispose of valuable assets in a divestiture firesale.

The point being made here is not that unilateral effects necessarily require market definition, high concentration levels, or a majority of customers who regard the merging parties as their first and second choices. Rather, it is that in the absence of some limits on the power of the government to find unilateral effects, the number of cases in which the government could make a mistaken prediction will be higher than in the presence of such limits. Thus, while the 2010 Guidelines provide transparency into the process that the government uses to evaluate mergers, they fail to fulfill another important function of Merger Guidelines, which is to let merging parties know *ex ante* whether a merger is likely to be challenged so they can accurately size and price the antitrust risk. In this context, it is worth noting that the 1968 Guidelines were a response, in part, to the 1955 Report of the Attorney General National Committee to Study the Antitrust Laws, which listed such a "dizzying list of factors" to evaluate the competitive effects of mergers that they provided the business community with no guidance at all.[18]

## Conclusion

The 2010 Guidelines make it difficult to provide meaningful counsel to merging parties on their likelihood of avoiding antitrust scrutiny in differentiated products markets where the answer to the question "do you compete head-to-head for some customers" is yes. This is especially true where there is significant opposition to the merger, even if that opposition comes from rivals who are willing to spend considerable resources to conjure up evidence that they cannot reposition their products. On the flip side, the courts are likely to put some limits on the ability of the government to act on predictions of the future, although that does not avoid the risk that mergers will be unnecessarily delayed, or even terminated, because of regulatory uncertainty. ●

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[14] "The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system." Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 407 (2004).

[15] Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 588 (1986).

[16] Toys "R" Us v. FTC, 221 F.3d 928, 937 (7th Cir. 2000).

[17] *See generally* FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109 (D.C. Cir. 2004).

[18] Derek C. Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 256–57, 271 (1960).

# 2010 Merger Guidelines: **Empirical Analysis**

**Jerry Hausman**

Empirical analysis of mergers has advanced significantly since the 1992 Guidelines were issued.[1] In particular, direct estimates of the outcome of mergers through the use of merger simulation models became widespread soon after 1992.[2] These models are quite useful in the analysis of potential unilateral effects arising in a merger involving differentiated products. Since merger simulation models are necessarily based on assumptions about how firms behave, the assumptions have implications which may not fit well in a particular situation and should be checked, when possible.[3] Nevertheless, merger simulation models have been used to analyze mergers in the United States, the European Union, the United Kingdom, Australia, New Zealand, Brazil, and Slovenia.

In considering the analysis of unilateral effects, the 2010 Guidelines are a significant advance over the 1992 Guidelines.[4] The 1992 Guidelines applied a market share benchmark of 35 percent and concentrated on whether a significant share of purchasers of one merging firm's product regard the other firm's product as their second choice.[5] However, this approach was misguided because market shares are indicative of consumer's second choices only if the "independence of irrelevant alternatives" (IIA) property holds for consumer demand. This property assumes that the choice between two competing products does not depend on what other products are available to a consumer. For example, the choice of a given consumer between a Bud Light and a Miller Lite does not depend on whether a Coors Light is also available. The implication for consumer demand is that diversion ratios are proportional to volume shares, which means that the products are "equally differentiated," in the common usage of economists. This assumption is unrealistic in many situations.[6]

Econometric tests that can be used to test the IIA property often reject it.[7] This finding also has implications for merger simulation models. Standard logit models typically should not be used in merger simulations models because at both the aggregate and individual levels they impose the IIA property. More flexible demand models should be used, such as the Almost Ideal Demand

1 U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (1992, rev. 1997) [hereinafter 1992 Guidelines], *available at* http://www.ftc.gov/bc/docs/horizmer.shtm.

2 *See, e.g.*, Jerry A. Hausman, Gregory Leonard & J. Douglas Zona, *Competitive Analysis with Differentiated Products*, 34 ANNALES D'ECONOMIE ET DE STATISTIQUE 159 (1994); Gregory J. Werden & Luke M. Froeb, *The Effect of Mergers in Differentiated Products Industries: Logit Demand and Merger Policy*, 10 J.L. ECON. & ORG. 407 (1994). I first presented a merger simulation model at a DOJ seminar in 1991, before the 1992 Guidelines issued.

3 *See, e.g.*, Dennis Carlton, *Does Antitrust Need to Be Modernized?*, 21 J. ECON. PERSP., Summer 2007, at 155; Jerry A. Hausman & Gregory K. Leonard, *Using Merger Simulation Models: Testing the Underlying Assumptions*, 23 INT'L J. INDUS. ORG. 693 (2005).

4 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.

5 1992 Guidelines, *supra* note 1, § 2.211.

6 *See, e.g.*, Jerry A. Hausman, *Project Independence Report: An Appraisal of U.S. Energy Needs up to 1985*, 6 BELL J. ECON. 517 (1975).

7 Jerry Hausman & Daniel McFadden, *Specification Tests for the Multinomial Logit Model*, 52 ECONOMETRICA 1219 (1984).

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System for continuous goods, and models that allow covariance to exist among the unobserved attributes for discrete goods.[8]

The 2010 Guidelines replace the market share approach for the analysis of differentiated product mergers with a diversion ratio approach that leads to calculation of "upward pricing pressure." The 2010 Guidelines explain that the diversion ratio is the fraction of unit sales lost by the first product due to an increase in its price that would be diverted to the second product. The use of diversion ratio analysis follows:

> Adverse unilateral price effects can arise when the merger gives the merged entity an incentive to raise the price of a product previously sold by one merging firm and thereby divert sales to products previously sold by the other merging firm, boosting the profits on the latter products. Taking as given other prices and product offerings, that boost to profits is equal to the value to the merged firm of the sales diverted to those products. The value of sales diverted to a product is equal to the number of units diverted to that product multiplied by the margin between price and incremental cost on that product. In some cases, where sufficient information is available, the Agencies assess the value of diverted sales, which can serve as an indicator of the upward pricing pressure on the first product resulting from the merger.[9]

In common with merger simulation models, using the value of diverted sales does not require market definition or the calculation of market shares or HHIs. This change is a significant advance over the 1992 Guidelines approach.

*In common with merger simulation models, using the value of diverted sales does not require market definition or the calculation of market shares or HHIs. This change is a significant advance over the 1992 Guidelines approach.*

Nevertheless, there are some limitations to the upward pricing pressure approach described in the 2010 Guidelines. The upward pricing pressure approach is essentially limited to the situation of a single product for each merging firm, while in reality many mergers of firms that produce differentiated products involve more than a single product each. An economic reason exists for this situation, since firms can introduce new products using brand recognition for existing products in a less costly manner, e.g., Honey Nut Cheerios, and these new products also sometimes permit higher prices for existing products.[10]

A more significant limitation is that the analysis considers the effect of the merger on only one product at a time when it is more informative to consider the effect on both products. The price of one product is held constant when the upward pricing pressure is computed for the other product, while in reality both prices will change in a merger. Consider as an example a product with a large amount of sales that merges with a product with a small amount of sales. The typical outcome is that the expected price change on the high sales product will be quite small, while the expected effect on the small sales product can be quite large. A weighted average of both price changes, where the weights are relative sales, is more informative than considering the expected effect individually by product. The upward pricing index for the two products cannot be combined in an informative manner by taking a weighted average.

However, the most significant shortcoming of the 2010 Guidelines approach is that the final result is an "upward pricing pressure" estimate, not the expected change in price, which is the focus of unilateral effects analysis of mergers of differentiated products and the measure (to first

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[8] For Almost Ideal Demand Systems used in merger simulation models, see Hausman et al., *supra* note 3. For discrete choice models that do not impose the IIA property at the individual level, see Martin Burda, Matthew Harding & Jerry Hausman, *A Bayesian Mixed Logit-Probit Model for Multinomial Choice*, 147 J. Econometrics 232 (2008).

[9] 2010 Guidelines, *supra* note 4, § 6.1.

[10] I analyze this outcome in Jerry A. Hausman, *Valuation of New Goods Under Perfect and Imperfect Competition*, *in* The Economics of New Goods 209–37 (Timothy F. Bresnahan & Robert J. Gordon eds., 1997).

order) of the change in consumer welfare. Expected changes in prices are also more straightforward to consider than a measure of upward pricing pressure.

In this article, I propose an alternative approach that uses the same information as the 2010 Guidelines' upward pricing pressure approach. Under my proposed approach, bounds are estimated for the predicted price changes using a merger simulation model. These estimated bounds are more informative than the upward pricing pressure estimates.

*[T]he most significant shortcoming of the 2010 Guidelines approach is that the final result is an "upward pricing pressure" estimate, not the expected change in price, which is the focus of unilateral effects analysis of mergers of differentiated products and the measure (to first order) of the change in consumer welfare.*

The diversion ratio is the key empirical factor needed in the 2010 Guidelines approach. I have significant concerns how this factor will be estimated by the Agencies. A risk exists that the Agencies' estimates will be "guesstimated" from a few of the merging firms' documents or customer interviews, or that an assumption equivalent to the IIA assumption will be used. In my view, an econometric demand model should be used to estimate the diversion ratio whenever possible.[11] In the following, I assume that a useable diversion ratio has been estimated and the Agencies have made an upward pricing pressure estimate for each merging product.

Here is how the cross price elasticities of demand can be recovered from the margin and the diversion ratio. The diversion ratio from product 1 to product 2 equals the ratio of the cross price elasticity of product 2 (with respect to the price of product 1) divided by the own price elasticity of product 1, multiplied by the ratio of unit sales of product 2 divided by the unit sales of product 1. Under the assumption of a single product firm, the own price elasticity is equal to the negative inverse of the price cost margin, $M_1 = -1/e_{11}$ where $e_{11}$ is the own price elasticity of demand for product 1 and $M_1 = (p_1 - mc_1)/p_1$ and $p_1$ is price and $mc_1$ is marginal (incremental) cost. The numerator of $M_1$ is also used to calculate the upward pricing pressure (for good 2) so no additional information is required. Thus, an estimate of the diversion ratio implies an estimate of the cross price elasticity, which is the fundamental economic measure of competition between two products.[12] Given the estimates of the cross price elasticities and the own price elasticities, predicted price changes follow from solving the two equations for $p = \{p_1, p_2\}$ the post-merger prices:[13]

$$s_1(p)e_{11}(p)\,\frac{p_1 - mc_1}{p_1} + s_2(p)e_{21}(p)\,\frac{p_2 - mc_2}{p_2} = -s_1(p)$$

$$s_1(p)e_{12}(p)\,\frac{p_1 - mc_1}{p_1} + s_2(p)e_{22}(p)\,\frac{p_2 - mc_2}{p_2} = -s_2(p)$$

where the e's denote the elasticities of demand, the s's are revenue shares, and the mc's are marginal cost.[14]

A potential concern with using this approach is that the results will depend on the particular shape of the demand functions because the elasticities, e.g., $e_{21}(p)$, depend on the prices that may change with the merger.[15] Econometric estimation will allow determination of the shape of the

[11] Of course, if an econometric demand model had already been estimated, there seems little reason not to perform a merger simulation rather than an upward pricing pressure calculation.

[12] In many situations estimation of one diversion ratio implies the value of the other diversion ratio, so only one diversion ratio needs to be estimated.

[13] Numerical computer software is necessary to solve the equations, but software currently exists that allows the equation to be solved with a Smartphone or a laptop computer. The equations are derived and explained in Jerry A. Hausman & Gregory K. Leonard, *Economic Analysis of Differentiated Products Merger Using Real World Data*, 5 Geo. Mason L. Rev. 321 (1997). Here I am holding prices of other goods constant as does the upward pricing pressure analysis of the 2010 Guidelines.

[14] The marginal costs may change with the merger due to economic efficiencies. I do not consider the analysis of efficiencies in this paper. For an analysis, see Jerry A. Hausman & Gregory K. Leonard, *Efficiencies from the Consumer Viewpoint*, 7 Geo. Mason L. Rev. 707 (1999).

demand curve and sensitivity analysis can be performed on the predicted price changes in a merger simulation model. Here I am limiting myself to the situation where an econometric demand system has not been estimated (perhaps due to lack of data) and I use the same data to calculate predicted price changes as the 2010 Guidelines use to estimate upward pricing pressure. A useful result is that one can demonstrate that a lower and upper bound for predicted price changes can be estimated using the above equations, in the class of generalized Box-Cox demand functions with "typical" (convex to the origin) shapes, using the linear demand curve to estimate the lower bound and the log-linear demand curve to estimate the upper bound.[16] Both of these demand curves are commonly used in economic analysis where the linear demand curve has prices and quantities in linear form and the log linear demand curve has prices and quantities in logarithmic form.

Data from an actual, recent merger analysis demonstrates this approach. Suppose a merger of two products is under analysis. The first product has a share of 38 percent and a gross margin of $M_1 = 0.45$. The second product is considerably smaller with a share of 4 percent and a gross margin of $M_2 = 0.30$. Assume the diversion ratios are 0.0334 (from the first product to the second product) and 0.1236 (from the second product to the first product), and the upward pricing pressure of the two products is 0.01 for the first product and 0.056 for the second product. These estimates are somewhat difficult to interpret given the absence of a natural calibration approach.

The own price elasticities and cross price elasticities required to solve for the price changes in the equations I discussed above can be estimated from the gross margins and the diversion ratios. With the linear demand curve assumption, the predicted price change for the larger product is a 0.6 percent price increase. The predicted price change for the smaller product is a 2.9 percent price increase. The weighted average price increase for the two products is 0.8 percent. Assuming that the non-merging firms do not increase their prices, the weighted average price increase for the entire category of products is 0.3 percent. These estimates provide a lower bound estimate. For the log-linear demand curve assumption, the predicted price change for the larger product is a 1.9 percent price increase. The predicted price change for the smaller product is an 11.2 percent price increase. The weighted average price increase for the two products is 2.8 percent. Assuming that the non-merging firms do not increase their prices, the weighted average price increase for the entire category of products is 1.2 percent. These estimates provide an upper bound for predicted price increases. The predicted price changes are straightforward to interpret in terms of the goals of merger analysis, which is to consider potential price changes arising from a merger and the effect on consumer welfare. They would seem small enough that no competitive concerns would arise.

These results should be interpreted with the well-recognized provisos that the bound calculations I have described here always lead to predicted price increases as long as the diversion ratios are greater than zero. Thus, the predicted changes should be substantial before significant concerns arise. Also, these calculations assume no entry or product repositioning will occur. Finally, price-decreasing effects of potential efficiencies (synergies) can be an important counteracting effect to potential price increases, as the 2010 Guidelines recognize. The upward pricing pressure

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[15] *See, e.g.*, Hausman & Leonard, *supra note* 13; Luke Froeb, Steven Tschantz & Gregory J. Werden, *Pass-Through Rates and the Price Effects of Mergers*, 23 INT'L J. INDUS. ORG. 703 (2005).

[16] See Jerry Hausman, *Sources of Bias and Solutions to Bias in the CPI*, 17 J. ECON. PERSP., Mar. 2003, at 23, and Hausman & Leonard, *supra* note 13, for a discussion of this type of analysis. Convexity to the origin follows from the usual assumption regarding marginal rates of substitution.

measure has the undesirable property that it will increase when efficiencies cause the marginal cost of the other merging product to decrease, but the estimated weighted average of price changes will typically not have this property.

I consider this predicted price change bounds approach to be superior to the 2010 Guidelines upward pricing pressure approach because predicted price changes are more straightforward to interpret in terms of the goals of merger analysis, which is to consider potential price changes arising from a merger and the effect on consumer welfare. At the same time, the bounds approach does not require any more information than is required to calculate the upward pricing pressure measure. ●

# Including Exclusion in the 2010 Horizontal Merger Guidelines

D. Bruce Hoffman and Daniel Francis

On August 19, 2010, the U.S. Department of Justice and the Federal Trade Commission issued revised Horizontal Merger Guidelines.[1] The 2010 Guidelines replace a 1992 version that was partially amended in 1997.[2] The new version differs markedly from its predecessor. Among other things, it signals a reduced focus on market definition and de-emphasizes bright-line tests. It also treats in detail a number of topics that were not extensively discussed in the 1992 Guidelines, and places heightened emphasis on particular microeconomic tools.

One significant change has not received much attention to date: the introduction into the Guidelines of an exclusionary analysis derived from Section 2 of the Sherman Act, which prohibits monopolization via exclusionary conduct. This change appears at several places in the new Guidelines. In particular:

- the list of statutes enforced by the Agencies through merger control now includes Section 2 of the Sherman Act[3];
- the "Overview" section now states that "[e]nhanced market power may also make it more likely that the merged entity can profitably and effectively engage in exclusionary conduct";
- a new section on sources of evidence now asserts that "rival firms may provide relevant facts, and even their overall views may be instructive, especially in cases where the Agencies are concerned that the merged entity may engage in exclusionary conduct"[4]; and
- the discussion of unilateral effects focuses on price, capacity, and innovation, but cautions that "[t]hese effects do not exhaust the types of possible unilateral effects; for example, exclusionary unilateral effects also can arise."[5]

Introducing into merger review a test for potential future exclusionary conduct might seem like an efficient "two-for-one" in cases where exclusionary concerns emerge during the merger control process. On closer examination, however, the new test likely cannot work. Moreover, we neither need such a test, nor—in light of its significant costs—would we want it.

## Section 2: Treading New Ground in Merger Review

Section 2 of the Sherman Act, which prohibits monopolization and attempted monopolization, lies at the heart of the antitrust laws. Properly interpreted and applied, Section 2 provides a valuable

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[1] *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (2010) [hereinafter 2010 Guidelines], *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf.

[2] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (1992, rev. 1997) [hereinafter 1992 Guidelines], *available at* http://www.justice.gov/atr/public/guidelines/hmg.htm. The 1997 amendment applied only to the 1992 Guidelines' efficiencies section.

[3] 2010 Guidelines, *supra* note 1, § 1 ("The relevant statutory provisions include Section 7 of the Clayton Act, 15 U.S.C. § 18, Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§ 1, 2, and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45.").

[4] *Id.* § 2.2.3.

[5] *Id.* § 6.

bulwark against certain kinds of anticompetitive exclusionary conduct and—although the boundaries of liability under monopolization law can be difficult to describe—it deserves vigorous, thoughtful enforcement. Nevertheless, in our view, the merger review process is not the proper forum for that enforcement.

As a historical matter, Section 2 has never been included in the list of statutory provisions that the Agencies have purported to enforce through merger control.[6] Moreover, to the best of our knowledge the Agencies have never challenged a horizontal merger that was otherwise unobjectionable on the ground that the firm, post-merger, might be more likely or better able to engage in exclusionary conduct in violation of Section 2.

It is true that in reviewing a relatively small subset of mergers, the Agencies have considered some very specific forms of exclusionary conduct. Thus, in vertical or partially vertical mergers—i.e., where the merging firms are not just competitors but also have operations at different levels of the supply chain—the Agencies have considered whether particular mergers might cause the merged firms to deny inputs or outputs to competitors post-merger, and have sometimes shaped merger remedies to address this concern.[7] But this relatively uncommon situation is a vertical issue, not a horizontal one (and, indeed, was addressed in the Non-Horizontal Merger Guidelines[8]). The new text seems to indicate that the Agencies have something quite different—and more expansive—in mind: specifically, exclusionary effects that are not directly or immediately linked to increased prices, reduced output, or constrained innovation. To that end, the 2010 Guidelines demand an inquiry into whether the merger would increase the ability and/or incentive of the merged firm to engage in exclusionary conduct at some unspecified future time. We think this approach raises intractable problems.

*To that end, the 2010 Guidelines demand an inquiry into whether the merger would increase the ability and/or incentive of the merged firm to engage in exclusionary conduct at some unspecified future time. We think this approach raises intractable problems.*

***An Intractable Task.*** Two aspects of the 2010 Guidelines' new inquiry make it unmanageable: the difficulty of identifying situations in which existing Section 7 law could not reach competitive concerns that would be caught by a Section 2 style "exclusion" analysis; and, the difficulty of defining and detecting "exclusionary conduct" in this context.

First, under Section 7, the Agencies can already block mergers where the evidence shows both that: (a) the merger will likely enable the merged firm (either by itself or in coordination with rivals) to harm consumers by raising prices, reducing output, or forestalling innovation; and (b) those potential harms outweigh any efficiencies from the merger.[9] Thus, in order for an "exclusionary" concern to arise that could *not* be adequately addressed under the 1992 Guidelines, one of two

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[6] *See* 1992 Guidelines, *supra* note 2, § 0 ("These Guidelines outline the present enforcement policy of the Department of Justice and the Federal Trade Commission . . . concerning horizontal acquisitions and mergers . . . subject to section 7 of the Clayton Act, to section 1 of the Sherman Act, or to section 5 of the FTC Act."); U.S. Department of Justice, Non-Horizontal Merger Guidelines § 1.0 ( 1984) [hereinafter 1984 Guidelines], *available at* http://www.justice.gov/atr/public/guidelines/2614.htm ("These Guidelines state in outline form the present enforcement policy of the U.S. Department of Justice . . . concerning acquisitions and mergers . . . subject to section 7 of the Clayton Act or section 1 of the Sherman Act.").

[7] *See, e.g.*, Press Release, U.S. Dep't of Justice, Justice Department Requires Northrop Grumman to Adopt Non-Discrimination Terms in Order to Consummate its Acquisition of TRW, Inc. (Dec. 11, 2002), *available at* http://www.justice.gov/atr/public/press_releases/2002/200543.pdf; Press Release, Fed. Trade Comm'n, FTC Approves AOL/Time Warner Merger with Conditions, (Dec. 14, 2000), *available at* http://www.ftc.gov/opa/2000/12/aol.shtm; Press Release, Fed. Trade Comm'n, FTC Settlement with Cadence, Cooper & Chyan to Preserve Competition in Automated Chip Design Software (May 8, 1997), *available at* http://www.ftc.gov/opa/1997/05/cadence.shtm.

[8] 1984 Guidelines, *supra* note 6, § 4.2 (noting the risks of competitive harm associated with mergers that require simultaneous entry into upstream and downstream markets, and indicating that "the Department will consider the likelihood of predatory price or supply 'squeezes' by the integrated firms against their unintegrated rivals").

[9] *See generally, e.g.*, U.S. Dep't of Justice and Fed. Trade Comm'n, Commentary on the Horizontal Merger Guidelines 2 (2006), *available at* http://www.justice.gov/atr/public/guidelines/215247.pdf.

situations would have to exist. The merged firm would either: (a) lack the power to raise price, reduce output, or reduce innovation; or (b) have this power, but enjoy efficiencies of such magnitude that any loss of competition would be offset by the firm's lower cost structures and the resulting consumer benefits. Put differently, the new exclusion test could come into play only when the merger somehow resulted in a merged firm that did not obtain market power (or that harnessed efficiencies sufficient to offset that power), but nevertheless gained some ability or incentive to engage, at some point in the future, in some form of exclusionary conduct that would, at some even more distant future date, allow it to acquire or maintain monopoly power.

Second, exclusionary conduct is notoriously difficult to define even after the fact (or indeed while the conduct is actually in progress), when at least we know what the putative monopolist is accused of doing.[10] Many of the practices that cause the most difficulties for antitrust courts under Section 2 offer short-run consumer benefits and help to drive down costs and yet, in certain circumstances, may drive rivals from the market and ultimately inflict net harm on consumers. Due in large part to these mixed effects, antitrust scholarship has yet to reach a consensus on where the line should be drawn between vigorous competition which benefits the consumer and anticompetitive exclusion which does not—and all this is quite apart from the difficulties of working out whether that line has been crossed in any individual case. In light of the significant practical and doctrinal difficulties in applying Section 2 to concrete facts, evaluating the effects and legality of hypothetical future conduct begins to look implausible.

Accordingly, the new test calls on the Agencies to challenge a class of mergers that would be procompetitive, or at worst neutral, under traditional Section 7 analysis for fear that the merged firm might engage in conduct that no one can readily identify and might or might not be harmful to consumers. We submit that if this can be done at all—and it probably cannot—it certainly cannot be done without a prohibitive risk of errors. There is simply no way an agency could predict with confidence that a merger that would not significantly harm competition would nevertheless facilitate some kind of future exclusionary conduct that would turn the merged firm into a monopolist. Indeed, it is far from clear that the Agencies can reliably predict even a merger's short-term price effects. The lack of empirical support for the accuracy of merger review or the efficacy of merger enforcement is one of the great challenges presently facing antitrust scholars, economists, and lawyers alike.[11]

***An Unnecessary Task.*** Regardless of whether this kind of "potential future exclusionary conduct" analysis is possible, it is unnecessary. If a reviewing agency were to conclude with the req-

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[10] *See, e.g.*, Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 767–68 (1984) (noting that "it is sometimes difficult to distinguish robust competition from conduct with long-run anti-competitive effects"); Frank H. Easterbrook, *When Is It Worthwhile to Use Courts to Search for Exclusionary Conduct?*, 2003 COLUM. BUS. L. REV. 345, 345 ("The big problem lies in this: competitive and exclusionary conduct look alike."); Einer Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L. REV. 253, 255 (2003) ("[F]or decades monopolization doctrine has been governed by standards that are not just vague but vacuous."); Kenneth L. Glazer & Abbott B. Lipsky, Jr., *Unilateral Refusals to Deal Under Section 2 of the Sherman Act*, 63 ANTITRUST L.J. 749, 749 (1995) ("Courts have long struggled to define the specific forms of business conduct that constitute monopolization under Section 2 of the Sherman Act."). Underscoring this uncertainty, by our highly unscientific count, in the last few years the *Antitrust Law Journal* has devoted no less than three symposia issues (plus many standalone articles) to the intense academic debate over how to identify exclusionary conduct. *See Symposium—Aspen Skiing 20 Years Later*, 73 ANTITRUST L.J. 59 (2005); *Symposium—Identifying Exclusionary Conduct Under Section 2*, 73 ANTITRUST L.J. 311 (2005); *Symposium: Issues at the Forefront of Monopolization and Abuse of Dominance*, 76 ANTITRUST L.J. 653 (2010).

[11] *See, e.g.*, Dennis W. Carlton, *Why We Need to Measure the Effect of Merger Policy and How to Do It*, CPI, Spring 2009, *available at* https://www.competitionpolicyinternational.com/why-we-need-to-measure-the-effect-of-merger-policy-and-how-to-do-it/; Orley Ashenfelter, Daniel Hosken & Matthew Weinberg, *Generating Evidence to Guide Merger Enforcement*, CPI, Spring 2009, *available at* https://www.competitionpolicyinternational.com/generating-evidence-to-guide-merger-enforcement/.

uisite certainty that the proposed transaction would give rise—on any coherent theory and in any reasonable time-frame—to market power that outweighed any efficiencies that it generated, then orthodox Section 7 enforcement would provide all the tools needed to block the merger or impose the necessary remedies. And if the merged firm were to behave anticompetitively in the future, there is no reason to think that the existing Section 2 and FTC Act Section 5 toolkit would not be up to the task. While litigating exclusionary conduct is difficult, much of that difficulty lies in determining the merits of the claims—a difficulty that is exacerbated, not reduced, when the analysis is conducted *ex ante* rather than *ex post*. Similarly, while Section 2 remedies can be challenging to develop and implement,[12] that task is certainly not *more* difficult after-the-fact—when the conduct has actually happened and been judged unlawful—than before-the-fact.[13]

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***A Costly Task.*** If adding this "pre-emptive Section 2" analysis to merger review did nothing worse than unnecessarily muddying the waters of an academic debate, then it might not be so objectionable. But we believe that expanding merger review to include prospective Section 2 enforcement would come with a high price tag—actually, at least five high price tags.

First, merger review is already staggeringly expensive and intrusive, and growing more so every day. Adding an inquiry into hypothetical exclusionary conduct to merger review could significantly expand the scope and burden of that process.

Second, not only does "exclusionary" conduct often look like procompetitive conduct, it commonly confers concrete benefits on consumers. Many types of "exclusionary" conduct under Section 2 involve the reduction of prices, at least in the short term; for example, it is only by careful analysis that one can target harmful predatory pricing without discouraging beneficial price competition. Explicitly conditioning merger approval on an agency's view of whether hypothetical future price cuts, bundled discounts, exclusive contracts, and so forth would threaten future competition could deter firms from considering (or implementing) such options even when consumers would benefit from them.

Third, for similar reasons, blocking or imposing conditions on a merger because of such concerns could actually harm competition—not merely by preventing the conduct itself but also by sacrificing all or part of the benefits of the merger. Recall that the mergers affected by the change would be those that would pass muster under "traditional" Section 7 analysis (i.e., mergers that are procompetitive or competitively neutral overall), but which nevertheless raise the specter of hypothetical conduct that might at some future time lead to exclusion and to competitive harm. Opposing such mergers because of the fear of future exclusion could kill the procompetitive bird in the hand in the mere hope of catching an anticompetitive bird that might not be in the bush at all.

Fourth, the new test increases the opportunities for competitive "gaming" of the review process. Competitors already have strong incentives to oppose procompetitive mergers, and they now have a whole new way to do so by advancing speculative theories of possible exclusionary conduct to the Agencies. This is not merely a hypothetical concern: the new Guidelines directly call for competitor input on the risk of future exclusionary conduct.[14]

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[12] *See, e.g.*, *Symposium: Remedies for Dominant Firm Misconduct*, 76 ANTITRUST L.J. 1 (2009); Renata B. Hesse, *Section 2 Remedies and* U.S. v. Microsoft: *What Is to Be Learned?*, 75 ANTITRUST L.J. 847 (2009); David A. Heiner, *Single-Firm Conduct Remedies: Perspectives from the Defense*, 75 ANTITRUST L.J. 871 (2009).

[13] Only in science fiction do we punish "offenders" for offenses that they have not yet committed. *Compare* MINORITY REPORT (DreamWorks/20th Century Fox, 2002).

[14] 2010 Guidelines, *supra* note 1, § 2.2.3.

Fifth, the speculative nature of exclusion analysis would exacerbate the general reduction in clarity in the new Guidelines. The 2010 revisions move away from clear declarations of agency practice and towards a more flexible and indeterminate description of factors that vary in significance from one case to the next. While the new text may indeed more accurately reflect agency practice, the change in style could undermine the usefulness of the Guidelines by making them less easily applicable by courts and less helpful to merging parties, and by reducing the "gravitational" unifying effect on agency practice that a clear, simple roadmap can offer.[15]

## Conclusion

There is no reason to think that existing law cannot adequately address concerns about exclusionary conduct that may arise from a proposed merger. Nor is there any reason to think that adding a speculative, hypothetical version of Section 2 analysis to merger enforcement will improve the benefits or lessen the burdens of merger review in any way. There is much reason to fear that Section 2's uncertainties, injected into merger review, will make that review more costly, more vulnerable to gamesmanship, less predictable, and less effective. The Agencies should tread this new and shaky ground with great caution. ●

[15] *See, e.g.*, D. Bruce Hoffman, *How Much Discretion Is Enough?*, The Deal (May 27, 2010), *available at* http://www.thedeal.com/newsweekly/community/judgment-call/how-much-discretion-is-enough.php.

# Pandora's Box Opened:
# The New Horizontal Merger Guidelines

**Gary Zanfagna**

At the 2009 ABA Antitrust Section Spring Meeting, I participated in a program titled "Revisiting the 1992 Merger Guidelines: Is It time to Open Pandora's Box?" On that program, I took the lonely position that revising the 1992 Guidelines was unnecessary, but not because merger analysis has remained stagnant in the past eighteen years. Of course some things have changed. For example, HHI thresholds outlined in the 1992 Guidelines are lower than those applied by the Agencies in practice today. But in general, the 1992 Guidelines continued to work well. As the Antitrust Modernization Commission concluded in 2007: "There's general consensus that the Merger Guidelines have acted as the 'blueprint [] for the architecture' of merger analysis and, overall, provide a guide that 'functions well'."[1] So why change a good thing? Do we know what we're getting into? In short, is it really time to open Pandora's Box?

Last fall, the Federal Trade Commission and the Department of Justice, Antitrust Division answered, "yes." One of my reservations about opening Pandora's Box was whether the Agencies would have the institutional commitment to take on such a big effort. I had the privilege of working on the Competitor Collaboration Guidelines several years back at the FTC and learned first hand the difficulties and challenges a project like that faces.[2] The process is time intensive, resource draining, and a distraction from other Agency priorities. It requires intra-agency cooperation and input from outside lawyers, economists, and businesspeople.

The Agencies put to rest that reservation of mine when they issued draft revised Guidelines in a lightning-fast seven months from the announced start. The Agencies deserve credit for committing the necessary resources and conducting an open process that sought the input of outside lawyers, economists, and business persons. After receiving comments and making further adjustments to the draft, the Agencies issued final revised Guidelines on August 19, 2010.[3]

I would describe the revisions in the new 2010 Guidelines as fitting into three categories. "As anticipated" is the first category. Most of the revisions fit into this first category. They are largely updates to the 1992 Guidelines that more accurately reflect actual Agency practice and thinking. These revisions are not controversial in the sense that they update the Guidelines while maintaining, by and large, the successful blueprint of the 1992 Guidelines. The second category of revisions is "hoped for a little more." In this category, because Pandora's Box was opened, I would have liked to see the Agencies go a little further with a few of the revisions. The third category is

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[1] Antitrust Modernization Commission, Report and Recommendations 54–55 (2007) [hereinafter AMC Report], *available at* http://govinfo.library.unt.edu/amc/report_recommendation/toc.htm.

[2] U.S. Dep't of Justice & Fed. Trade Comm'n, Antitrust Guidelines for Collaborations Among Competitors (2000), *available at* http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf.

[3] 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.

"wait and see." This includes revisions that, in my view, push the envelope on accepted economic theory and merger analysis. I refer to this category as "wait and see" because the open question is how the Agencies will use these new tools in practice.

## "As Anticipated" Revisions

Most of the revisions update the Guidelines to more accurately reflect current Agency practice and thinking. The 2010 Guidelines move away from the more rigid, linear analysis outlined in the 1992 Guidelines and call for a "fact-specific" assessment that is focused on the likely competitive effects of a potential transaction.[4]

One way the Agencies emphasize the fact-intensive nature of merger analysis in the new Guidelines is by introducing a new Section 2, Evidence of Adverse Competitive Effects. This section discusses the "categories and sources of evidence that the Agencies . . . have found most informative in predicting the likely competitive effects of mergers."[5] Although a new addition to the Guidelines, Section 2 simply confirms what we already knew about the types and sources of evidence relied upon by the Agencies.

*Although a new addition to the Guidelines, Section 2 simply confirms what we already knew about the types and sources of evidence relied upon by the Agencies.*

There are a few points in Section 2 that I would have considered putting in the "wait and see" category if the Agencies had not made further revisions before issuing the final Guidelines. For example, in Section 2.2.1, the Agencies clarified in the final 2010 Guidelines that "[setting] price well above incremental cost" is not in itself anticompetitive and further clarified and defined incremental cost.[6] The Agencies also clarified in Section 2.2.1 that a purchase price "in excess of the acquired firm's stand alone market value" is not necessarily an indicator of a likely anticompetitive effect but may simply indicate that the acquiring firm is paying a premium "because it expects to be able to . . . achieve efficiencies."[7]

A departure from the 1992 Guidelines is the treatment of market definition. Unlike the 1992 Guidelines that formalistically began with market definition, the 2010 Guidelines state that the "analysis need not start with market definition."[8] The 2010 Guidelines use market definition as a tool to help discern the likely competitive effects of a transaction.[9] This approach more accurately reflects how the Agencies, in my experience, already treat market definition in merger analysis. It also reflects more accurately how clients are counseled. I do not remember ever advising a business executive on a proposed transaction with a detailed discussion of market definition. SSNIP (small but significant and non-transitory increase in price) is not an acronym of interest to a busy executive.

After the draft Guidelines were issued in April, some expressed concern that revisions to the market definition section may be intended to de-emphasize the necessity or importance of market definition in merger analysis.[10] I do not think that is the case. In the final version of the 2010

4 The Overview states: "[Merger analysis] is a fact-specific process through which the Agencies . . . apply a range of analytical tools to the reasonably available and reliable evidence to evaluate competitive concerns . . . ." *Id.* at 1.

5 *Id.* at 2.

6 *Id.* at 4.

7 *Id.*

8 *Id.* at 7.

9 "The Agencies define relevant markets to help analyze the competitive effects of a horizontal merger. Market definition is not an end in itself: it is one of the tools the Agencies use to assess whether a merger is likely to lessen competition." *Id.*

10 General Electric Company, United Technologies Corporation and Honeywell International Inc., Comments to the Federal Trade Commission and Department of Justice on the Proposed Horizontal Merger Guidelines (June 4, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00028.pdf.

Guidelines, the Agencies clarified that they "will normally identify one or more relevant markets in which the merger may substantially lessen competition."[11] More importantly, the Agencies are bound by case law[12] and Section 7[13] itself, which require identifying a relevant market. The Agencies would be unwise to go to court without including market definition in their case.

## "Hoped for a Little More" Revisions

There are a few areas where I wish the revisions had gone a little further. For example, Section 10, Efficiencies, is largely unchanged from the 1992 Guidelines, as amended in 1997. While the 1997 efficiencies amendment took a huge leap forward by formally recognizing the relevance of efficiencies in merger analysis, the 2010 Guidelines barely tiptoe forward.

First, the 2010 Guidelines continue to concentrate on static efficiencies, cost savings that reduce prices to consumers in the short term.[14] Little credit is given to fixed-cost savings that reduce total costs in the longer run but may not necessarily have an immediate impact on short-term prices to consumers.[15] As the AMC Report pointed out, in the long run, fixed cost savings are likely to benefit consumers as well and should be given more credit than they generally have received.[16]

In my experience, companies expend tremendous effort on identifying, quantifying and committing to achieve all likely cost savings in a transaction. The 2010 Guidelines could have given greater weight to all verifiable cost savings that reduce total costs in the long run and make the combined entity more efficient and competitive.

Second, the 2010 Guidelines continue to discount dynamic efficiencies relating to research and development that can spur innovation. The 2010 Guidelines explain that those efficiencies "are potentially substantial but are generally less susceptible to verification . . . ."[17] Verifiable or not, these efficiencies are extremely important. At the ABA Antitrust Section Innovation Symposium earlier this year, innovation experts were incredulous at the notion that short-term price benefits to consumers from verifiable cost savings could be more important to competition than longer term innovation efficiencies.[18] Despite the difficulty of quantifying and verifying innovation efficiencies, the 2010 Guidelines could have better recognized the significance and importance of innovation efficiencies in competition.

## "Wait and See" Revisions

There are a few revisions that are "wait and see" because they possibly go beyond accepted economic theory and merger analysis. The issue is how the Agencies will use these new tools in practice.

One of the revisions in the "wait and see" category is the introduction of Upward Pricing Pressure (UPP) theory in Section 6.1, Prices of Differentiated Products. It is perhaps not surpris-

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11 2010 Guidelines, *supra* note 3, at 7.

12 FTC v. Lundbeck, Inc., Civil No 08-6379 (D. Minn. Aug. 31, 2010); FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109 (D.D.C. 2004).

13 Section 7 of the Clayton Act, 15 U.S.C. § 18.

14 2010 Guidelines, *supra* note 3, at 31 n.15.

15 *Id.*

16 AMC Report, *supra* note 1, at 58.

17 2010 Guidelines, *supra* note 3, at 31.

18 Antitrust and Innovation Symposium, co-sponsored by the ABA Section of Antitrust Law and Stanford Law School (May 20–21, 2010).

ing to see UPP theory introduced here because it was developed in an academic article by Carl Shapiro and Joseph Farrell, the current chief economists at the Agencies.[19] However, the theory raises concern because it almost always predicts some price increase resulting from a horizontal merger.[20] While the theory may be one tool that is part of a competitive effects analysis, placing too much weight or reliance on that theory could be misleading and inaccurate. Time will tell how the Agencies choose to use this tool.

Another revision I would include in the "wait and see" category is the inclusion of "reduction in product variety" as an independent anticompetitive effect in Section 6.4, Innovation and Product Variety.[21] Although the Agencies attempted to clarify this theory through further commentary and an example in the final 2010 Guidelines, there is still little guidance for parties to determine whether and how the Agencies would find an anticompetitive effect from a proposed combination, apart from any impact on price or quality, based solely on a theory of "reduction in product variety." Time will tell how the Agencies choose to use this new tool as well.

*The Agencies opened Pandora's Box. They deserve credit for quickly and efficiently managing to close it.*

## Conclusion

The Agencies opened Pandora's Box. They deserve credit for quickly and efficiently managing to close it. Most of the revisions in the 2010 Guidelines appropriately reflect current Agency practice and thinking. Of course, there are a few areas where I would have "hoped for a little more" and a few areas where we will have to "wait and see" what the Agencies do with their new tools. Most importantly, though, the Agencies have managed to preserve the well-functioning "blueprint for the architecture of merger analysis" from the 1992 Merger Guidelines by concentrating revisions on updating the Guidelines to more accurately reflect current Agency practice and thinking. At the end of the day, the Agencies must challenge a merger in court with testimony by customers and others, with documentary evidence, and with empirical evidence supported by credible theories of competitive harm in a relevant market.[22] The 2010 Guidelines will be used and tested in that context. ●

19 Joseph Farrell & Carl Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition*, B.E. J. THEORETICAL ECON. vol. 10, no. 1, art. 9 (2010), http://www.bepress.com/bejte/vol10/iss1/art9.

20 Dennis W. Carlton, *Comment on Department of Justice and Federal Trade Commission's Proposed Horizontal Merger Guidelines*, June 4, 2010, *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00034.pdf.

21 "If the merged firm would withdraw a product that a significant number of customers strongly prefer to those products that would remain available, this can constitute a harm to customers over and above any effects on the price or quality of any given product." 2010 Guidelines, *supra* note 3, at 24.

22 The FTC's view that it needs only to establish "substantial questions," rather than "likelihood of success on the merits," as does the DOJ, at the preliminary injunction stage in federal court to halt a transaction, FTC v. CCC Holdings, 605 F. Supp. 2d 26 (D.D.C. 2009), is a separate issue from the 2010 Guidelines that in practice creates an irreconcilable difference in merger enforcement between the FTC and DOJ when applying the same 2010 Guidelines.