Economists Incorporated

EconomistsINK

May 2010

A BRIEF ANALYSIS OF POLICY AND LITIGATION

Special Issue: The New Draft Horizontal Merger Guidelines

FTC and DOJ Release Draft of Revised Horizontal Merger Guidelines

Lona Fowdur

Lona Fowdur is a senior economist with EI and has analyzed the antitrust implications of several mergers and acquisitions in the energy and health care industries.

On April 20, 2010, the Department of Justice (DOJ) and the Federal Trade Commission (FTC) released for public comment proposed revisions to the Joint FTC/DOJ Horizontal Merger Guidelines that have been in effect since 1992. The proposed revisions aim to bridge the gap between the existing guidelines and current Agency practice and to reflect advances in economic knowledge and legal precedent from the past 18 years. The new draft Guidelines reduce the emphasis on the five-step evaluative approach that spanned market definition, competitive effects, entry, efficiencies, and failure. While retaining and expanding the discussion of each of these steps, the draft Guidelines favor a more flexible approach where the Agencies could use a variety of tools to analyze whether a merger would substantially lessen competition.

Under the draft Guidelines, market definition will no longer be the necessary first step to analyze competitive effects, and the delineation of a relevant market with precise boundaries will not always be required. Nevertheless, the draft Guidelines retain the hypothetical monopolist test for market definition. The draft Guidelines have also revised market concentration triggers upwards to better reflect current enforcement practices. For example, in the 1992 Guidelines, mergers were presumed to enhance market power if they increased the Herfindahl-Hirschman Index (HHI) by over 100 points to a post-merger level above 1800. The draft Guidelines require an increase of over 200 points to a level over 2500.

The draft Guidelines significantly expand the discussion of competitive effects. They highlight that the measurement of unilateral price effects need not rely on market definition, market shares, and concentration. The draft Guidelines discuss several analytic methods that may help assess unilateral effects, including diversion ratios, critical loss, upward pricing pressure, analysis of consumer switching patterns, and merger simulation. The revised section on unilateral effects also discusses markets characterized by auctions and competitive effects on innovation and product variety. The section on coordinated effects now includes an expanded discussion of factors that make a market more vulnerable to coordinated interaction and theories of potential harm from coordinated conduct.

The draft Guidelines include a new section that describes the types and sources of evidence that the Agencies might rely on. The types of evidence include experience from already consummated mergers and historical events, existing market shares and concentration levels, and the elimination of head-to-head competition or of "maverick" firms. New sections on powerful buyers, mergers between competing buyers, and partial acquisitions have also been included.

Also in this issue

Some Unexpected Implications of the Draft Horizontal Merger Guidelines

Barry C. Harris finds that the new draft Guidelines have a very different focus than the existing Guidelines. Unlike the earlier Guidelines, the draft Guidelines focus on the analytic techniques and evidence that the Antitrust Agencies will use to predict a merger's competitive effects. While the changes embodied in the draft Guidelines probably will make challenges to mergers more likely, some of the techniques described may affect the outcome of merger analysis in ways not contemplated by the Agencies. In particular, the use of profit margins described in the draft Guidelines may raise issues for the Agencies' analysis of unilateral and coordinated competitive effects. In general, this technique will not advance the analysis of unilateral effects. Moreover, it may indicate that a merger cannot have coordinated anticompetitive effects.

Market Definition Flexibility Under the Draft Horizontal Merger Guidelines

Steve Stockum finds that the draft of the revised Guidelines greatly alters the Agencies' approach to market definition. The draft Guidelines downplay the importance of market definition and describe a preference for narrow markets, even independently of the results of the analytical tests used in market definition. The preference for narrow markets will likely be reinforced by the new prominence that the draft Guidelines give to price discrimination. But the draft Guidelines do not properly distinguish between differential pricing and price discrimination. The increased flexibility in market definition in the draft Guidelines may make challenges to mergers more likely.

Some Unexpected Implications of the Draft Horizontal Merger Guidelines

Barry C. Harris

The focus of the draft Guidelines is quite different from that of the 1992 Guidelines. The draft Guidelines describe the principal analytical *techniques* and the main types of *evidence* on which the Department of Justice and Federal Trade Commission (the Agencies) usually rely to predict whether a horizontal merger may substantially lessen competition, while the 1992 Guidelines describe the analytical *framework* and *specific standards* used by the Agencies. The draft Guidelines further indicate that "merger analysis does not consist of uniform application of a single methodology" but rather "is a fact-specific process through which the Agencies…apply a range of analytical tools." While largely retaining the unifying theme of the 1992 Guidelines to prevent the increase of market power, the draft Guidelines are more of a discussion of the "tool kit" the Agencies employ.

The draft Guidelines identify a range of techniques, including many that are not directly contemplated in the 1992 Guidelines. While the changes embodied in the draft Guidelines probably will make challenges by the Agencies more likely, some of the newly introduced techniques may affect the outcome of merger analysis in ways not contemplated by the Agencies. These techniques include the use of value added to measure price (Section 4.1.2); geographic markets based on the location of suppliers (Section 4.2.1); the introduction of critical loss analysis (Section 4.1.3), particularly when markets are defined by targeting customers; and the introduction of diversion ratios and simulation methods (Section 6.1). This article considers one of these techniques, use of a firm's product-specific pre-merger profit margins to measure the demand elasticity it faces for that product, and explains why its application may indicate that many mergers have little or no impact on competition.

Section 4.1.3 of the draft Guidelines explains how a theoretical relationship between pre-merger margins and demand elasticity will be used in the market definition process. Specifically, the draft Guidelines state that unless the firms in a market are engaging in successful coordinated interaction, high pre-merger margins normally indicate that each firm's product individually faces demand that is relatively inelastic and not highly sensitive to price. The draft Guidelines further indicate that high pre-merger margins make it likely that there is little substitution with products outside a candidate market, and, thus, suggest that markets should be defined narrowly.

Barry C. Harris, EI's Chairman of the Board, is a former Deputy Assistant Attorney General for Economics at the Antitrust Division of the United States Department of Justice.

The presumed relationship between margins and demand elasticities, however, presents some logical complications for the Agencies, in large part because the pre-merger margins of a specific firm can at most reflect the demand elasticity facing that particular firm for a specific product. If a firm's pre-merger margin implies a low overall elasticity for a product, then it also implies low cross elasticities between that product and every other product, whether the other product is inside or outside the defined market. Importantly, these presumed low cross-elasticities also indicate that the products in the defined market are differentiated and not homogenous and that the products of the merging parties are not close substitutes.

The use of margins to indicate elasticities, however, is unlikely to advance the Agencies' analysis of unilateral and coordinated competitive effects. Unilateral effects analysis involving differentiated products principally depends on whether the products of merging firms are each other's closest substitutes. Ascertaining whether products are closest competitors does not depend on the absolute level of the substitution between the products of the merging firms but, rather, on how this substitution compares with the extent of substitution with products of non-merging firms. Ironically, the draft Guidelines make a related point in Section 2.1.4, where it discusses the importance of head-to-head competition between products of the merging firms as being "especially relevant for evaluating adverse unilateral effects." The pre-merger margins of the merging firms are not useful for this purpose.

These implications for coordinated effects analysis are more striking, since the principal analytical reason to define a market is to evaluate the likelihood of coordinated effects involving relatively homogenous goods, a situation inconsistent with low cross-elasticities. Homogenous products necessarily have high cross-elasticities with each other. Consequently, under the presumed margins-elasticity relationship, high pre-merger margins imply that sellers of these products have successfully coordinated their pricing. Thus,

continued on page 4

Market Definition Flexibility Under the Draft Horizontal Merger Guidelines

J. Stephen Stockum

The draft Merger Guidelines downplay the importance of market definition considerably and provide insights into the Agencies' approach to market definition beyond the parameters of the hypothetical monopolist test. The emphasis is on flexibility, which implies that different fact situations can lead to defining relatively narrow markets, defining multiple markets, and bypassing market definition entirely.

Whereas the 1992 Guidelines state "[t]he Agency will *first* define the relevant product market . . ." (Section 1.1, emphasis added), the draft Guidelines emphasize that "[t]he Agencies' analysis need not start with market definition." (Section 4) Indeed, the introductory section of the draft Guidelines' market definition section (nine paragraphs) emphasizes that "the Agencies implement these principles of market definition flexibly" and predominantly provides reasons why market definitions might be misleading and why defining markets may not be a necessary analytical step at all. For example, the draft Guidelines suggest jumping ahead to competitive effects analysis "[w]here analysis suggests alternative and reasonably plausible candidate markets."(Section 4) So rather than having to support a proposed relevant market, the Agencies seem to suggest that the step may be an unnecessary impediment to assessing the competitive effects of a proposed merger.

"...application of the draft Guidelines will no longer necessitate performing competitive effects analysis within a well-defined (and well-supported) relevant antitrust market"

Still, market definition remains a significant part of merger analysis. The hypothetical monopolist test (which the draft Guidelines have maintained) will define a market that in some cases might seem broad, and in other cases might seem narrow. The fact that the result of the test seems broad or narrow should not be used to determine the validity of that result. Nonetheless, the draft Guidelines assert that "[d]efining a market broadly . . . can lead to misleading market shares" and "[m]arket shares of different products in narrowly defined markets are more likely to capture the relative competitive significance of these products . . . ." (Section 4)

The 1992 Guidelines say that "[t]he Agency generally will consider the relevant product market to be the smallest group of products that satisfies the [hypothetical monopolist] test." (Section 1.11) Still there is a substantial difference between this statement and the position of the draft Guidelines. It is one thing to describe how the objective nature of the hypothetical monopolist test leads to the relevant market being the narrowest set of products for which the hypothesized price increase is profitable. It is quite another matter to express a prosecutorial preference for narrow markets independently of the parameters of the analytical test itself.

J. Stephen Stockum, EI Principal, formerly was an economic advisor to an FTC Commissioner. He has advised clients on the antitrust implications of a large number of mergers and acquisitions in a wide variety of industries.

The draft Guidelines explain that when "relatively distant" competitors are brought into the provisional market via the hypothetical monopolist test, the result may be "overstating their competitive significance as proportional to their shares in an expanded market." (Section 4) But those competitors would not be brought into the market by the analytical test in the first place unless they were able to defeat an anticompetitive price increase. The competitors obviously are important in a true economic sense. Under the 1992 Guidelines, the competitive significance of firms within the relevant market is addressed only under competitive effects analysis. The revision appears largely to blur the boundary between market definition and analysis of competitive effects. It appears that application of the draft Guidelines will no longer necessitate performing competitive effects analysis within a well-defined (and well-supported) relevant antitrust market.

Other language in the draft Guidelines also suggests that the Agencies may often define very narrow markets. For example, the Agencies may identify relevant markets defined around customers that could be targeted for a price increase. (Section 4.1.4) While defining such "price discrimination markets" is not new to the draft Guidelines, the high degree of prominence of this topic is new. The old Guidelines mention price discrimination only in the section on market definition, measurement, and concentration. The draft Guidelines Section 3, which is devoted entirely to price discrimination, states that "[t]he possibility of price discrimination influences market definition (See Section 4), the measure-

continued on page 4

Some Unexpected Implications

continued from page 2

if these high margins have persisted for an extended period, then application of the margin-elasticity relationship implies that successful coordination is likely with or without the merger. While the draft Guidelines indicate mergers should not be permitted to entrench market power, successful coordination that persists for an extended time is already entrenched and unlikely to be affected by the merger.

Historically, an argument that a merger would not harm competition because prices were already at monopoly levels has been rejected by the Agencies, largely because the merger could increase the likelihood that successful coordination would continue. The persistence of high pre-merger margins, however, indicates that the likelihood of successful coordination was already high and will not increase significantly. The reasons for this possible conclusion are discussed in the draft Guidelines, which recognize that successful coordination may reflect market conditions other than the number of competitors. For example, Section 7.2 observes that successful coordination is more likely when a firm's competitive initiatives can be promptly and confidently observed by its rivals, an observation consistent with the economics literature. Whether these conditions exist typically depends on the nature of a product and its uses, which means that these types of conditions are likely to persist in a particular market. The persistence of these conditions, when coupled with persistent high pre-merger margins and homogenous products is one type of historical event that Section 2.1.2 indicates is informative regarding the competitive effects of a merger. Here the history of the market suggests that a merger that reduces the number of competitors may not significantly affect the ability to exercise market power. The economic literature that applies dynamic game theory to various oligopoly models has noted similar results.

How the new techniques in the draft Guidelines will affect analyses of future mergers is unclear, but some of the effects may be different than are currently anticipated. The use of pre-merger margins to indicate elasticities of demand in particular may have significant implications for competitive effects analysis. In general, this technique will not advance the analysis of unilateral effects. Moreover, it may indicate that a merger is unlikely to cause anticompetitive coordinated effects.

Market Definition Flexibility

continued from page 3

ment of market shares (see Section 5), and the evaluation of competitive effects (see Sections 6 and 7)."

The draft Guidelines not only dramatically raise the prominence of price discrimination, they also make it sound remarkably easy to accomplish. As described in the draft Guidelines, price discrimination only requires two conditions: "differential pricing and limited arbitrage." Differential pricing requires only that the suppliers "must be able to price differently to targeted customers." But economics textbooks emphasize that price discrimination only occurs when differential prices are not explained by differential costs, including costs of manufacture, sale, delivery, and other more subtle cost differences, such as potential costs due to uncertainty. This critical economic element of price discrimination, which seriously limits the extent to which differential prices may imply anticompetitive price discrimination, is nowhere to be found in the greatly expanded treatment of price discrimination.

This focus on narrow market definitions alone would not always lead to stricter enforcement, because it might in some instances lead to markets that exclude one of the parties, thus preventing the Agencies from challenging certain mergers. Other language in the draft Guidelines, however, seems to work against that possibility. "The hypothetical monopolist test . . . *does not* lead to a single relevant market." (Section 4, emphasis added) While this statement may be true of the particular example (Example 6) preceding the quote, that fact pattern does not appear to be common. The necessary fact pattern for multiple markets to exist under the hypothetical monopolist test is that there are multiple firms, or groups of firms, whose products each individually have sufficient substitutability with the products of the merging parties that adding each one of those products into the provisional market separately satisfies the test. The Agencies' emphasis of this point appears intended to maintain flexibility to define multiple markets, one of which may include both the merging firms' products.

The extent to which the courts may deferentially read the draft Guidelines to lessen the Agencies' burden of proof regarding relevant market definition is yet to be seen. The degree to which the proactive tone and aggressive analytical techniques of the draft Guidelines may deter parties from even attempting many efficiency-enhancing and competitively-innocuous mergers and acquisitions may never be known. One thing that is known is that the Agencies will use inventive analytical approaches to pinpoint plausible threats to competition, in significant part by adding a great deal of flexibility to their approach to market definition.

Economists INCORPORATED

Merger Analysis at EI

Economic analysis is a central feature of courts' and agencies' evaluation of the antitrust implications of mergers. The enforcement agencies use economic analysis to define relevant markets, to analyze competitive effects, and to determine how other factors, such as ease of entry and efficiencies, likely will influence the effects of mergers. Overall, the antitrust review of mergers has become a joint effort of attorneys and economists.

Mergers are an important part of EI's practice. We have consulted with merging parties and government agencies and testified about market definition, market power, competitive impact, entry conditions, efficiencies, and failing company analyses. Our experience includes oral and written testimony in hundreds of litigated matters. The insights of EI economists go quickly to the heart of the antitrust issues and help attorneys craft legal strategies.

EI economists have had more than 100 years of combined employment experience at the Department of Justice and the Federal Trade Commission. With this experience, we understand the concerns of antitrust enforcement officials. We can spot issues that are likely to be raised by the antitrust agencies. Our economists help assess the likelihood of government involvement in a contemplated merger, enabling the client to make well-informed strategic decisions. By focusing the analysis on the important issues in a timely manner, our presentations of economic arguments to the enforcement agencies have helped to terminate merger investigations before the Second Request stage or before the parties have to comply fully with Second Requests that have been issued. In addition to their federal antitrust experience, our economists also have significant experience dealing with, and working for, state and foreign antitrust enforcement agencies.

Economists INCORPORATED

OFFICES:

1200 New Hampshire Avenue, NW
Suite 400
Washington, DC 20036
[p] (202) 223-4700
[f] (202) 296-7138

5980 Horton Street
Suite 250
Emeryville, CA 94608
[p] (510) 547-6910
[f] (510) 547-5162

www.ei.com

President
Jonathan L. Walker

Editor
Henry B. McFarland

Layout
Gregory E. Wurz

in association with
The Allen Consulting Group in Australia