LECG

HMG Review Project – Comment, Project No. P092900
Comments on Questions 2, 4, and 13

Cleve B. Tyler[1]
LECG, LLC
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Response to Question 2:

The Guidelines should be revised to discuss evidence considered regarding competitive effects. However, extended comments in the Guidelines themselves regarding the specifics of different types of competitive effects evidence might not be a positive change. The Guidelines should provide a clear guide to the methodology followed by the Agencies both in their internal review of potential mergers and in litigation, should that stage be reached. A thorough review of the types of evidence used for competitive effects analysis in the Guidelines will either be incomplete or make the Guidelines too long, impacting the Guidelines' ability to be a clear guide.

Therefore, I think it is more appropriate to discuss this evidence briefly in the Guidelines (in section 2.2) perhaps listing the types of evidence considered in competitive effects, and to develop a separate document that discusses the application of the Merger Guidelines, including this area, in depth (similar to some of the discussions in the Commentary on the Merger Guidelines). However, in doing so, any comments relating to the use of types of evidence used in evaluating competitive effects should reflect the benefits and shortcomings of each type of evidence.

a. <u>Consummated Merger</u>. For an already consummated merger, evidence of actual adverse competitive effects is the most direct empirical evidence of a problem with the merger. If the agencies are investigating an already consummated merger, then there should be heighted attention paid to demonstrating convincingly that there are anti-competitive effects from the merger. After all, in a consummated transaction actual information will almost always be available to test the effects of the merger. Therefore, analysis related to this actual information should be a central focus of the investigation.

However, the available evidence should be evaluated in the appropriate context. For instance, post-merger price-increases might be construed to be evidence of competitive effects, but might be benign if costs have increased in the industry since the merger. Post-merger evidence of competitive effects should be supported by relevant and reliable analysis that evaluates prices (or other indicators of any changes in competition) that takes into account relevant factors that may impact prices such as cost, entry and or exit by other parties, product repositioning, demand, regulations, etc.

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[1] Cleve B. Tyler is a Senior Managing Economist at LECG, LLC. The comments in this document represent the views of the author and do not represent the views of LECG or other experts at LECG.

b. Natural Experiments. The use of natural experiments represents a reasonable approach to evaluating the likely effects of a merger.[2] Not all natural experiments are equal, however, and the Guidelines (or comments thereon) should make this clear. A good natural experiment presents a situation occurring or that has occurred in the industry that effectively simulates what is likely to happen in the event of a merger. Focusing on exit by the one of the merging parties across geographic markets is an example (however, even in this instance, one would want to understand the reasons for the exit to fully evaluate the appropriateness of this experiment).

c. Parties' Post-Merger Plans. The merging firms' post-merger plans should be given somewhat limited weight. Documents are subject to interpretation and post-merger plans are not an exception. Post-merger planning documents may represent one person's view of the post-merger world or a particular scenario that a person was asked to consider. Therefore, post-merger plans are useful not so much in evaluating the potential impact of a merger on competition itself, but in understanding the key products and market participants, to the extent that these are identified in the market plans. Market plans also may be helpful in designing other analyses or understanding the context of other analyses performed.

d. Evidence from Customers. Customer responses can be useful in terms of eliciting information about how customers would respond to hypothetical price increases – either to help estimate diversion ratios or in defining an antitrust market or markets. A question often asked of customers is what they would do in response to a 5 or 10 percent price increase – in particular, what other products they would switch to and why. However it is also important to understand how much substitution would take place in addition to whether any substitution would take place in order to properly address either diversion ratios or the market definition question.[3] The agencies should consider the full range of customer responses (and not just a selected group) because similarly situated customers may nevertheless respond to a price increase in different ways.

However, customer responses to hypothetical questions should be taken with a grain of salt – more important are concrete examples that the customers can provide about specific actions taken in the past (or plans for action), documented where possible. In particular, customer responses can be used to help understand why a particular natural experiment is appropriate or not, as well as help understand the context of any competitive effects analysis. The agencies should understand that customers may use involvement in the merger review process as a strategic bargaining chip to gain a better deal with suppliers, especially in instances where customers and suppliers negotiate the contractual terms of sales.[4]

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[2] For an expansive discussion of the use of natural experiments, see: Coleman, Mary and James Langenfeld, "Natural Experiment Analysis: The Use of *Daubert* Criteria to Evaluate Its Relevance and Reliability," ABA Section of Antitrust Law, Issues in Competition Law and Policy, 2008.

[3] This point is also made by Dennis Carlton: Carlton, Dennis W. "Does Antitrust Need to be Modernized," *Journal of Economic Perspectives*, 21:3 (Summer 2007), p. 162.

[4] I am aware of actions undertaken by customers while a merger investigation was ongoing that are best construed as gaining a superior bargaining position with the merging parties.

e. Head to Head Competition Evidence. So long as there is overlap, one would expect to see head-to-head competition between the merging parties. The question becomes how important is this evidence. One can use evidence of head-to-head competition to assess the closeness of the products in question and to attempt to understand the diversion ratio, that is, the proportion of sales that would likely flow from one of the merging firms to the other in the event of a price increase. In assessing whether the head to head competition is "significant" and to evaluate diversion ratios properly, the agencies should consider the full range of head-to-head competitions in the industry. The evidence may show dozens of instances of head-to-head competition which might be "significant" if there were one hundred overall competitions in the industry, but might not be "significant" if there were in fact thousands of overall competitions.

In assessing the significance of competition, the agencies must also be cognizant of selection bias. There will be information related to competition (say in the form of bidding for contracts) easily accessible from the merging parties, however, this information may be of limited value without some reasonable estimate of the totality of competitions. There may be a number of competitions in which neither of the merging parties participated or only one of the parties participated but were not captured in the data available.

f. Historical Evidence of Coordination. The focus on historical instances of coordination in an industry really represents a lack of the ability to predict when coordination is likely to appear going forward. As Carl Shapiro has said, "Economic analysis regarding unilateral effects is more amenable to quantification than is economic analysis of the dangers of collusion."[5] Historical evidence of coordination, of course, does not mean that coordination will happen going forward, so this evidence should be given somewhat limited weight in estimating the likely effects of a merger in the future.

However, coordination or attempted coordination between one of the parties and others in the industry can raise a red flag to indicate that careful scrutiny should be paid to the possibility of coordination. But it is important to remember that the analysis regarding coordination should focus specifically on the incremental impact of the merger itself. If the historical instances of coordination can be linked to the merger then the use of historical coordination makes analytical sense, much in the way that natural experiments can be used as discussed above. This involves understanding the nature of the prior history of coordination and showing that the merger under investigation has likely increased the probability of coordination in the form that occurred historically.

[5] Address by Carl Shapiro, "Mergers with Differentiated Products," before the ABA, Washington DC, November 9, 1995 (www.justice.gov/atr/public/speeches/shapiro.spc.htm).

Response to Question 4:

The Guidelines should not be adjusted to reflect the suggestion in number 4 that the hypothetical monopolist test be simplified so that any collection of substitute products may constitute a relevant market if a hypothetical monopolist would find it possible impose a small but significant and non-transitory increase in price (SSNIP). Nor should the "smallest market" principle be abandoned.

Adopting the suggestions in question 4 would lead to some markets that would be overbroad and would result in a wide array of markets that could be defined. In particular, such a principle would allow the government agencies to cherry-pick certain products to be included in a proposed market that might result in condemnation of a merger that is otherwise not anticompetitive. For example, consider two companies where each has a 12.5 percent share of a properly defined market using the smallest market principle, such that the market share of the combined firm would be 25 percent. Let's say that each company also offers a product (products A and B) for which there is some substitution with the products in the defined market, but not enough to bring either product A or B into the market. The sales of both product A and B are twice the sales associated with the 12.5 percent share in the defined market. Also, products A and B have minimal substitution between them. If one were to abandon the smallest market principle and add products A and B to the alleged market, then the combined share of the merging parties in this proposed market would be 50 percent as opposed to the 25 percent using the smallest market principle.

One might argue that the agencies wouldn't do this, and that defining a broader market will generally lead to lower shares for the merging parties. However, the broader point is that adopting proposal 4 would result in greater subjectivity in the analysis of mergers and less certainty for the merging parties. The parties would have to consider all combinations of products that the agencies might string together and the potential competitive effects in all of these potential markets.

To the extent that the agencies are concerned that the "smallest market principle" results in too many markets to analyze in certain circumstances, or redundancy in analysis, recall that the Commentary on the Horizontal Merger Guidelines discusses that "when the analysis is identical across products or geographic areas that could each be defined as separate relevant markets using the smallest market principle, the Agencies may elect to employ a broader market definition that encompasses many products or geographic areas to avoid redundancy in presentation."[6] This comment then refers to the Merger Guidelines footnote 14 which states, in part, "If production substitution among a group of products is nearly universal among the firms selling one or more of those products, however, the Agency may use an aggregate description of those markets as a matter of convenience."[7]

[6] Commentary on the Horizontal Merger Guidelines, Federal Trade Commission and U.S. Department of Justice, 2006, pp. 8-9.
[7] Merger Guidelines, § 1.321 n.14.

Notice that the Commentary is somewhat different than the Guidelines. The Guidelines *would* benefit from a more explicit discussion (not in a footnote) about when aggregation can occur and specify that this can happen when there is identical or substantially identical analysis across products due to supply substitution.

Response to Question 13:

There are different standards for uncommitted entry and committed entry in the Guidelines. The specific distinctions between uncommitted and committed entry are somewhat arbitrary – uncommitted entrants would respond within one year without "significant" sunk costs of entry and exit in response to a small and significant, non-transitory increase in price (SSNIP); committed entrants respond to a SSNIP within two years where this entry is timely and likely (i.e. profitable at pre-merger prices).[8] It is not entirely clear when sunk costs would be considered "significant" and why one year is the appropriate cut-off between uncommitted and committed entrants.

That being said, there necessarily must be some structure that allows one to assess the importance of an entrant on competition in the event of a merger. Some competitors may have an impact on prices pre-merger (uncommitted entrants and perceived potential competitors) and could continue to have an impact on prices post-merger and may prevent any post-merger attempt at a price increase. Committed entrants are further removed from having an impact on market prices today, but likely would enter later with sunk costs incurred. The current distinction seems reasonable.

Companies that are uncommitted entrants (as defined in the current Guidelines) should be considered market participants and assigned weight in market shares. However, in practice the Agencies seem highly skeptical about labeling a firm an uncommitted entrant and giving it weight in the market share calculation and subsequently including these firms in the competitive effects discussion. Neither the Merger Guidelines nor the Commentary on the Horizontal Merger Guidelines provides guidance on how the Agencies assess potential uncommitted entrants in practice – for instance, at what level do sunk costs become significant. In this case, some discussion with actual examples could be helpful in a Commentary on the Merger Guidelines (though not necessarily in the Guidelines themselves).

Uncommitted entrants should be assigned weight according to the capacity that could be used in the defined market or according to sales that are estimated would be part of the defined market in question. Making this estimate depends upon the best information available. It is important to recall that the assignment of market share in the early stages of merger review (when uncommitted entrants would be counted) is done simply to evaluate whether the merging parties fall into a safe harbor in one or more defined markets. However, the decision to include or exclude a firm as an uncommitted entrant can have ramifications for the competitive effects analysis.

Evaluating whether an uncommitted entrant impacts competition is a matter of judgment based on a review of various pieces of economic evidence.[9] Such evidence may include the past

[8] The third aspect of committed entry is sufficiency which is important in evaluating the overall effects of the merger, but not important when it come to defining an entrant as uncommitted, committed, or neither.

[9] Retrospective merger studies may be able to provide additional guidance here. In particular, one could review the behavior of uncommitted entrants (or claimed uncommitted entrants) in consummated mergers (especially when prices increased) to see in what circumstances these firms entered the defined market.

behavior of the company (or similar companies) in question, a technical assessment of whether a company could make a product (and what is required in making a switch), and testimony from the company about what it would do in the event of a price increase in the relevant market. The market presence of uncommitted entrants may be evaluated by using natural experiments either with the firm in question or by evaluating the impact of other entry (or perhaps even exit) in the industry. In short, many of the tools that are used to assess competitive effects can be used to evaluate the impact on competition of an uncommitted entrant.