Comments Submitted to the Horizontal Merger Guidelines Review Project of the Federal Trade Commission and Department of Justice

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INTRODUCTION

The Horizontal Merger Guidelines Review Project is an important opportunity to bring the Merger Guidelines into closer conformity with industrial organization economics and with merger review practice at the Federal Trade Commission and the Antitrust Division of the Department of Justice. These comments are intended to draw attention to one aspect of the current Guidelines that diverge from modern economics and from actual practice, as well as from past Merger Guidelines and from guidelines in other countries, and to urge that the Merger Guidelines be revised to remedy this issue. The issue concerns mergers that eliminate a potential competitor that constrains incumbent behavior.

The 1982 Merger Guidelines recognized what it termed the "theory of potential competition," wherein a non-incumbent firm might sufficiently constrain incumbents' behavior that its elimination by merger with an incumbent could trigger antitrust scrutiny. The Guidelines discussion distinguished actual from perceived potential competition, asserted that such mergers would be evaluated according to the same analytical method as for mergers between incumbents, and indicated a safe harbor when entry was easy or where comparable entry advantage was shared by more than three potential competitors. While the 1984 revision to the Guidelines left these provisions unchanged, beginning with the 1992 revision, this entire discussion was deleted, leaving no explicit mention of potential competition mergers in those or the 1997 further revisions.[1]

This downgrading of attention to mergers involving the elimination of potential competition in the 1992 Guidelines was ironic, if not paradoxical, since a major focus of that revision to the Guidelines was to strengthen and clarify discussion of entry conditions and in particular to specify criteria for determining whether those conditions negated the otherwise anticompetitive effects of a merger between incumbents. Thus, even as the Guidelines elevated entry as a defense for merger, they downgraded the significance of the offense of merging to eliminate the constraint posed by a potential entrant.

These comments recommend the restoration of the doctrine of potential competition to its former place in the guidelines. In particular, there should be an explicit provision stating that a merger eliminating a constraining potential competitor or a potential competitor otherwise planning entry raises competitive concerns and may be challenged on those grounds. In addition, some guidance should be offered as to how such mergers will be reviewed. The remainder of these comments reviews the relevant economic theory and empirical evidence concerning potential competition, discusses some significant recent mergers involving potential competitors, and proposes a standard by which such mergers might be analyzed.

[1] An accompanying statement asserted that there was "no change in...policy toward non-horizontal mergers," a category that included potential competition mergers. It was nonetheless clear that potential competition concerns had been downgraded.

THE MODERN ECONOMICS OF POTENTIAL COMPETITION MERGERS

Economic theory and empirical evidence reinforce the proposition that a merger that eliminates a potential competitor may relax the competitive constraint on incumbent behavior, thereby permitting incumbents to decrease output and raise price and harming both consumers and overall market efficiency. This proposition follows since a potential competitor may be a source of supply response similar to that represented by an existing competitor. That is, to the extent that its possible new output via de novo entry represents a threat that deters incumbent output reduction, merger between the incumbent and that potential competitor predictably results in a price increase.

Economic models of entry, of incumbent behavior, and of merger–some traditional, others more recent and directed at these questions--establish a number of propositions concerning the effects of a merger eliminating a potential competitor.[2] The key propositions are as follows:

(1) It is often profitable for an incumbent to merge with a constraining potential entrant. This is more likely the case when there are few incumbents and few potential entrants.

(2) Consumers are harmed by the elimination of a constraining potential entrant in the same circumstances as such mergers are profitable.

(3) Both the profit effect and the consumer harm are smaller in the case of a merger eliminating a potential competitor than in the case of a merger between two incumbent competitors.

(4) When there are multiple potential entrants or when the incumbent and the potential entrant sell differentiated products, the effects of a merger persist but are smaller in magnitude.

These predictions are corroborated by a growing number of empirical studies. These fall into two categories: studies of the price-decreasing effects of the existence of potential entrants, and studies of the price-increasing effects of merger eliminating a constraining potential entrant. The constraining effects of having firms well-positioned to enter a market are demonstrated in a number of studies in the airline industry together with others from railroads, cable TV, and pharmaceuticals.[3] These studies confirm the effect and show it to be smaller in magnitude than

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[2] These are reviewed in J. Kwoka, "Eliminating Potential Competition," in *Issues in Competition Law and Policy*, Dale Collins, ed, 2008; also, J. Kwoka, "Mergers That Eliminate Potential Competition," December 16, 2009, forthcoming in *Research Handbook on the Economics of Antitrust Laws*, Einer Elhauge, ed., available at **http://www.ios.neu.edu/j.kwoka/PCMergers.pdf**

[3] These studies are reviewed in J. Kwoka, "Non-Incumbent Competition: Mergers Involving Constraining and Prospective Competitors," 52 *Case Western Reserve Law Review* 2001; also, J. Kwoka, forthcoming, supra, note 2.

the effect of reducing the number of incumbent competitors, much as theory predicts.

One recent study has directly examined the price effect of a merger between an incumbent and a potential entrant. This study, also in airlines, drew the following relevant conclusions:[4]

(1) A substantial and significant price increase results in markets where the merger involved an incumbent that eliminated a potential entrant. This effect is larger than that associated with a simple reduction in the number of anonymous potential entrants, since merger combines two particular firms.

(2) This effect is smaller than in markets where the two firms faced each other as incumbents.

(3) The effect is smaller in markets where incumbent competition is stronger (since there is little opportunity for price increase) and also where the incumbent is already dominant (since prices are already higher).

(4) The size of the potential entrant's operations is less important to its constraining impact than its mere presence at the edge of the market.

Thus, economic theory and empirical evidence are clear and consistent in their conclusions regarding potential competition and mergers involving potential competitors: Potential competition can constrain the exercise of market power among incumbents, and hence the elimination by merger of a constraining outside competitor can cause consumer harm analogous to that arising from a merger between incumbents.

RECENT MERGERS INVOLVING POTENTIAL COMPETITION

Despite the change in the Merger Guidelines, mergers raising issues of potential competition have occurred with continued frequency. A few--notably, Staples-Office Depot[5]--have gone to trial and been successfully challenged. While that case hinged primarily on actual competition between the merging parties, a companion allegation was that the merger eliminated one of the only two possible entrants into single-seller local markets for consumable office supplies sold through office superstores.

Another relevant category consists of mergers for which investigations were closed after full consideration of their potential competition concerns, or those that have resulted in settlements of such concerns with the parties–but in neither case involving trial. Prominent among these have been two airline mergers. The proposed merger of United and USAir in 2000 was abandoned after the Justice Department indicated its opposition on grounds of diminution of

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[4] J. Kwoka and E. Shumilkina, "The Price Effect of Eliminating Potential Competition: Evidence from an Airline Merger," *Journal of Industrial Economics*, forthcoming; available at **http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1275841**

[5] *FTC v. Staples, Inc.*, 970 F. Supp 1066 (D.D.C. 1997)

both actual and potential competition.[6] The recent merger of Delta and Northwest was approved but undoubtedly raised similar issues.[7] Other prominent potential competition cases that were resolved without trial were Google-Doubleclick and Ticketmaster-Live Nation. The Federal Trade Commission approved the former, concluding from its investigation of whether "the transaction threatened to eliminate potential competition in any relevant market" that there was no cause for concern.[8] Most recently, the Justice Department threatened suit, gained concessions, and then settled a possible case against the merger of Ticketmaster and Live Nation. The DOJ statement noted that one of the likely effects of the merger, if consummated, would be that "actual and potential competition between Ticketmaster and Live Nation in the provision and sale of primary ticketing services for major concert venues will be eliminated."[9]

Given the frequency and importance of cases involving the elimination of potential competition, it is not helpful to observers, and anomalous in the Merger Guidelines, that those Guidelines are entirely silent on such mergers. They provide no guidance as to how such mergers are evaluated, and indeed, do not even confirm that such mergers may represent violations of the Guidelines. As noted, however, earlier FTC/DOJ Merger Guidelines did so.

Moreover, competition policy guidelines in most developed countries do in fact contain explicit references and standards for mergers involving potential competitors. For example, the 2004 EC Merger Regulation asserts that a merger eliminating a potential competitor will be challenged if "there should not be a sufficient number of other potential competitors which would exert the same competitive pressure as the merging potential competitor."[10] The UK Enterprise Act, the German Principles of Interpretation of Merger Control, the Canadian Merger Enforcement Guidelines, and the Japanese Guidelines to Application of the Antiomonopoly Act, among other countries' standards, also include explicit provisions governing such mergers.[11]

TOWARD GUIDELINES FOR POTENTIAL COMPETITION MERGERS

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[6] "U.S. Department of Justice and Several States Will Sue to Stop United Airlines from Acquiring U.S. Airways," Department of Justice, Washington, DC, July 17, 2001.

[7] The Justice Department closing statement on this investigation did not mention potential competition issues, but such concerns were widely believed relevant.

[8] "Statement of the Federal Trade Commission Concerning Google-DoubleClick," FTC File No. 071-0170, 2007.

[9] Complaint, U.S. et al. v. Ticketmaster Entertainment and Live Nation, Department of Justice, Washington, DC, January 25, 2010, ¶ 48.

[10] Council Regulation (EC) 139/2004, 20 January 2004, "The Control of Concentration between Undertakings," 2004 O.J. (L.24) 1-22 at ¶ 73.

[11] For a review of these statutes and standards, see Kwoka, 2008, op. cit., note 2.

In fashioning a Guidelines approach to mergers involving potential competition, the fundamental principle need not differ from that which now guides analysis of mergers among incumbents: the elimination of a firm that "matters," in the sense its presence significantly alters market equilibrium, is competitively suspect. Thus, mergers that eliminate potential competitors that matter should also be subject to antitrust scrutiny.

Identification of potential competitors that matter could borrow from the current Guidelines criteria for the "entry defense." As adapted to potential entry, those criteria are:[12]

(1) The potential entrant has the capability of entering within two years.

(2) The potential entrant would likely find entry profitable if price were to rise by 5 percent.

(3) The potential entrant could enter at a scale sufficient to reduce price by a small but significant and nontransitory amount, or could enter at a smaller scale but have the capability and incentive to expand substantially within a period of two years.

Economic theory and empirical work suggest a fourth criterion, namely:

(4) The firm is significantly better positioned than any other possible entrant or one of no more than about three equally well-positioned potential entrants.

I would propose that a merger involving an incumbent firm and a potential competitor meeting these four criteria should be presumed anticompetitive and evaluated by the agencies accordingly.

In any particular investigation, evidence bearing on these criteria could take one of several forms: (1) documents from the potential entrant that indicate a serious interest in possible entry, the basis for that interest, and the capability of undertaking such entry; (2) documents from the incumbent demonstrating belief in the possibility of entry by the potential competitor or demonstrating actions taken or considered as responses to past or prospective actions by the potential competitor; or (3) objective facts and data about the possible entrant that establish its incentive and capacity to enter. Any of these would establish that the firm in question matters to market equilibrium and therefore its elimination by merger is likely anticompetitive.

CONCLUSION

As this discussion makes clear, the present FTC-DOJ Merger Guidelines err in their silence concerning mergers that eliminate potential competitors affecting market equilibrium. I urge that the Guidelines be modified to make such mergers an explicit concern of enforcement policy and to offer guidance along the lines suggested here as to how such mergers are to be evaluated. Such changes will simultaneously bring the Guidelines into conformity with industrial organization economics, with actual merger enforcement practice, and with common practice in other countries.

[12] These proposed criteria are taken from Kwoka, 2001, note 3.