Comments on:

Horizontal Merger Guidelines for Public Comments Released On April 20, 2010

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0 Overall Reactions

The Federal Trade Commission and U.S. Department of Justice (Agencies) deserve credit for deciding to issue for public comment the draft Horizontal Merger Guidelines.[1] The Draft Guidelines take important steps towards better communicating the Agencies' approach to merger enforcement, not least because the exposition often is more accessible and the discussion of some subtle points has been elaborated.

Substantively, the Draft more accurately reflects the Agencies' actual practice.[2] The Draft also represents an improvement in that it follows the 2006 Commentary on the Horizontal Merger Guidelines in recognizing the usefulness of careful empirical analysis of evidence on key issues in the analysis of likely effects of a merger, including the extent of direct competition among merging firms, the effects of past entry, exit, and merger events, and the experience of firms in achieving forecast efficiencies.

Having acknowledged the significant advances made in the Draft, we are concerned that, in several places, the Draft might be construed to signal an overly aggressive approach to enforcement rather than clarifying existing practice. This could have the unfortunate effect of deterring efficient mergers. We identify some examples in the remainder of these Comments.

1 Inferences from High Margins in Industries with Large Fixed Costs

Section 2.2.1 (p. 4) gives an example of how decisions taken by the merging firms can be informative about industry conditions: "if a firm sets price well above marginal cost, that normally indicates either that the firm is coordinating with its rivals or that the firm believes its customers are not highly sensitive to price."

Some readers might read this to mean that there is something inherently anti-competitive about high margins and mistakenly advocate for regulatory intervention. We appreciate that as a matter of economic theory, the statement in the Draft is correct. In particular, charging high margins is a firm's unilaterally optimal decision when "customers are not highly sensitive to price." Industrial organization economists further recognize (1) that such relatively inelastic demand can reflect a host of legitimate factors, such as a firm's product characteristics,

[1] Horizontal Merger Guidelines for Public Comment: Released on April 20, 2010, Federal Trade Commission and U.S Department of Justice (hereinafter Draft Guidelines or Draft).

[2] For example, the Draft Guidelines note the risk of defining a market too broadly (which can lead to misleading market shares and can overstate the constraints faced by the merging firms) and that the "Agencies usually evaluate mergers in the smallest relevant market satisfying the hypothetical monopolist test," but they sensibly avoid saying that the analysis must always focus on the narrowest market. This flexibility can help avoid needless objections to potentially meritorious merger challenges. If a merger can be shown to pose a competitive problem in a broader market, there should be no need to examine whether a problem also arises in the narrowest market.

reputation, or intellectual property; and (2) that high margins need not indicate supracompetitive profits when firms must incur significant fixed costs (as is common in R&D intensive or other capital intensive industries). To avoid the risk of misinterpretation, we suggest adding a sentence that high margins do not create a presumption of illegitimate conduct, abnormal profit, or an anticompetitive outcome.

To further balance the discussion on inferences from high margins, we would suggest the Guidelines recognize the limits of the accounting data, which often are the most readily available information, to estimate margins. It is non-controversial that accounting data will often not accurately reflect economic margins.[3]

2 Targeted Customers and Price Discrimination

Section 3 of the Draft appropriately states that the possibility of price discrimination by the merging firms can affect several aspects of the merger analysis. The Draft notes two common preconditions for price discrimination: the need to identify customers' demands and set different prices ("differential pricing") and limited scope for arbitrage. The discussion, however, exclusively stresses reasons why price discrimination may be feasible,[4] e.g., factors that can limit arbitrage.

This approach risks creating the impression that significant price discrimination is the norm. But it is generally recognized that, besides arbitrage, there are other impediments to price discrimination, including economies of uniformity in advertising prices when using media that cover relatively broad markets, marketing advantages from simplicity and uniformity in pricing, and various transaction costs to a firm from having different prices.[5] The Guidelines, therefore, should balance this discussion to note that there are other obstacles to price discrimination.

3 Diversion Ratio and Upward Pricing Pressure (UPP)

Section 6.1 of the Draft discusses the unilateral price effects of a merger involving differentiated products. The Draft takes the economically sound position that, when firms' products are significantly differentiated, it is appropriate to investigate the extent of direct competition between the merging firms' products relative to competition they face from other

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[3] See, e.g., Franklin M. Fisher and John McGowan, "On the Misuse of Accounting Rates of Return to Infer Monopoly Profits," *American Economic Review* 73, no. 1 (1983): pp. 82–97; Jeffrey M. Perloff, Larry S. Karp and Amos Golan, *Estimating Market Power and Strategies* (New York: Cambridge University Press, 2007), pp. 15–18.

[4] Draft Guidelines, pp. 6–7: see Example 3 and the two paragraphs following it.

[5] See Marius Schwartz and George Rozanski, Comments on Potential Revisions to the Horizontal Merger Guidelines, submitted November 9, 2009 (hereinafter Schwartz and Rozanski 2009), pp. 8–9: http://www.ftc.gov/os/comments/horizontalmergerguides/index.shtm.

products. The Draft goes on to say that the Agencies sometimes may seek to quantify such head-to-head competition by estimating the *diversion ratio* from one merging firm's product to the other's product (and vice versa). The diversion ratio and the margin between price and incremental cost on the second product (to which sales are diverted when the price of the first product is raised) "can serve as an indicator of *upward pricing pressure* on the first product resulting from the merger." (Emphasis added)

We recognize this approach can have value, but want to reiterate some important points from our initial comments on the risks of placing too much reliance on diversion ratios and UPP to predict merger effects.[6]

Diversion Ratios

An accurately measured high diversion ratio from product *A* to product *B* would be strong direct evidence that *B* is an especially close substitute to *A*. The diversion ratio from *A* to *B* seeks to measure what share of the reduction in *A's* sales in response to an increase in its price would be recaptured by *B*, holding other relevant variables constant. The Guidelines should caution, however, that the diversion ratio often cannot be accurately estimated.

- One issue is noisy data, such as incomplete or unreliable win-loss data compiled by the firms. As a second example, often a company may track the product to which it is losing customers but may not know the reason; in particular, a company may not know whether switching was in response to a price increase (as is required to estimate the diversion ration) or some other factor.

- Another problem is that the natural experiment needed to generate the data for estimating a diversion ratio — such as variations in price caused by changes in supply conditions — is often lacking.

- Even if a suitable natural experiment has been observed, the price increase for product *A* may have been short lived or smaller than the threshold for concern in a merger. If so, the historical diversion ratio from *A* to *B* may understate the substitution to other products that would result following a hypothesized anti-competitive merger involving suppliers of *A* and *B*. For example, an alternative product *C* may be an attractive substitute for *A provided* its suppliers make some necessary investments (e.g., to reposition it) or customers make some such investments (e.g., to adapt their equipment to work with *C* or, in the case of differentiated consumer products, to identify and try unfamiliar alternatives), but such investments would only be worthwhile in the event of a larger and more durable price increase on good *A* than observed in the past data.

[6] See Schwartz and Rozanski 2009, Section 3, pp. 9–15.

This discussion is not meant to dismiss the value of the diversion ratio as an analytical tool. However, the Draft's discussion of diversion ratio would be strengthened by noting that this suggestive direct evidence needs to be supplemented by examining the underlying fundamental factors that could explain why the products are especially close and durable substitutes. An inquiry into the relevant product attributes, the requisite assets needed to provide these attributes, and which firms possess such assets should be undertaken in order to validate the impressions gleaned from diversion ratios. Absent such validation, an estimated high diversion ratio is less probative. Similar comments apply to the discussion of evidence on buyers' preferences that appears in Section 6.2 of the Draft.

UPP

As noted above, the Draft states that the value of sales diverted to the merged firm's product *B* as a result of an increase in the price of product *A* (i.e., the diversion ratio from *A* to *B* multiplied by the margin on *B*) can serve as an "indicator" of the upward pricing pressure on product *A* due to the merger. The term "indicator" need not imply a presumption that the merger will result in a significant price increase, and we reiterate the pitfalls of using UPP alone to establish such a presumption.

The oligopoly-pricing model assumed in most merger simulations (static differentiated-products Bertrand competition) will predict *some* price increase if the merging firms' products are substitutes in demand and have positive margins — meaning that they are even slightly differentiated from substitute products sold by other firms. Recognizing this implication, Professors Joseph Farrell and Carl Shapiro, now chief economists at the Agencies, have warned against using a predicted price increase from such modeling as sufficient grounds to challenge a merger.[7] "Rather, one would look for [the predicted upward price pressure] to be in some sense 'substantial.'"[8]

This important point is absent from the Draft Guidelines (possibly because, as noted above, the Draft does *not* suggest that positive UPP is enough to establish that a merger is presumptively harmful). In order to better guide potential merging parties, the Guidelines should include this discussion and reiterate that a merger will be challenged only if the predicted price increase is significant.

Similarly, the possibility that a merger could reduce marginal costs and that this could reverse any upward pricing pressure is not mentioned in Section 6.1 of the Draft, but deferred

[7] "But it would be a radical (and highly questionable) policy to forbid all mergers [whose price is predicted to rise at all based on such a theory] . . . and it would presumably be wasteful overkill to flag all such mergers as presumptively problematic." Joseph Farrell and Carl Shapiro, "Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition," working paper, University of California-Berkeley, 2008 (Farrell and Shapiro 2008), pp. 9–10 http://faculty.haas.berkeley.edu/shapiro/alternative.pdf.

[8] *Id.*

until Section 10 on efficiencies. In contrast, Farrell and Shapiro (2008) suggest that some reduction in marginal cost might be presumed as a way to avoid scrutinizing virtually every merger involving substitute differentiated products. Under that approach, one would look at the net UPP, that is, after having accounted for the downward pressure on prices that would result from a reduction in marginal cost.[9]

In short, while UPP is a valuable concept, we suggest the Draft Guidelines acknowledge its limitations.

4 Efficiencies

The Draft (p. 2) correctly notes that enhanced market power can be manifested not only through a higher price but also in non-price terms that harm customers, "including reduced quality, reduced product variety, reduced service, or diminished innovation." In parallel fashion, it should be noted that potential efficiencies from a merger also could manifest themselves in any of these dimensions.

Instead, the Draft (p. 30) gives an example of how cognizable efficiencies can reverse a merger's potential to harm consumers, "e.g., by preventing price increases in that market." By definition, an example is not exhaustive, but this may give the impression that price is the only term that matters. We suggest the Guidelines expand this example with additional non-price terms, and observe that consumers can benefit on balance from price and non-price efficiencies created by a merger.

An obvious way for consumers to benefit would be if the merger raises product quality and causes the quality-adjusted price to fall. Apart from quality improvements, consumers could benefit despite a price increase if a merger led to increased product variety. The basic point here is to avoid an overly narrow view of efficiencies and to dispel any impression that consumers can only benefit if price falls.

5 "Neutral" Motives For Mergers

Understandably, the Draft focuses on potentially anti-competitive effects of horizontal mergers and on offsetting cognizable efficiencies. In the absence of credible efficiencies, the Agencies naturally tend to look for anti-competitive effects as the motive for a merger. However, mergers arise for a range of reasons that are neither anti-competitive nor pro-competitive. For example, an acquiring firm may be more bullish than the acquired firm on the industry's prospects and, hence, on the value of the acquired assets. Such informational differences are not themselves a cognizable efficiency. But they provide a rationale for the merger not based on anti-

[9] Farrell and Shapiro (2008), pp. 10–12.

competitive harm and, hence, avoid a default inference that the motive must be anti-competitive if cognizable efficiencies cannot be documented. It would, therefore, be useful to recognize the possibility of such "neutral" motives.