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

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HMG REVISION PROJECT – COMMENT, PROJECT NO. P092900

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U.S. DEPARTMENT OF JUSTICE AND
FEDERAL TRADE COMMISSION
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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 welcome the opportunity to comment on the U.S. Department of Justice's and Federal Trade Commission's revised Horizontal Merger Guidelines ("Guidelines"). The agencies' goal of "increasing the transparency of the analytical process underlying the Agencies' enforcement decisions"[1] is laudable, and it should allow companies to more accurately assess how the antitrust authorities will review their transactions and enable companies to make more informed transaction decisions. We also applaud the agencies' decision to seek public comment on this issue again. Such transparency in governmental policy-making is welcome.

We raise three concerns, however, regarding how the Guidelines will be perceived by courts and other antitrust enforcement officials, both in the United States and overseas. First, there is a risk that Section 6.1 of the Guidelines – which incorporates concepts outlined in scholarly work developing the upward pricing pressure, or UPP, test[2] – will be misapplied to condemn procompetitive or competitively neutral deals. Second, the Guidelines may be misread to imply that prices exceeding marginal cost signal market power. Third, courts and other enforcement officials may overread the caveats surrounding the Guidelines' commendable statement about fixed-cost efficiencies. We address each of these points in turn.[3]

I. Section 6.1: UPP Test

The Guidelines play an important role not just as a reflection of the agencies' methods of merger review, but as a guide to courts and as a potential model for enforcement officials overseas. In light of that, 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. Experimental tools that have not yet been shown to be reliable should not be included in the Guidelines. Indeed, it would be premature to do so. Experimental tools may need to be modified as the agencies gain more experience with them and learn how they are best used. Enshrining an early version of a tool in the Guidelines today prevents that evolution.

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[1] Federal Trade Commission & U.S. Department of Justice, *Horizontal Merger Guidelines for Public Comment* (April 20, 2010) at 1 [hereinafter "Guidelines"].
[2] Joseph Farrell & Carl Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition,* 10 B.E. JOURNAL OF THEORETICAL ECONOMICS (2010).
[3] We share concerns raised by many of the other comments filed in response to these Guidelines. We have limited our comments here, however, to these three areas, in light of the brief time available for comments.

As noted in our companion paper by Dennis Carlton, the UPP test is as yet untested and is not yet backed by sound empirical support.[4] Indeed, in rejecting a (tardy) effort to invoke the UPP test in a merger case, a district court has recently noted that it had been unable to find "a single decision of a federal court adopting this test."[5] More empirical study needs to be conducted before any such test is enshrined in the Guidelines.

Moreover, the UPP test has the potential to generate false positives, particularly in the hands of antitrust enforcers and decision-makers who overestimate its powers and underestimate its limitations. As the Carlton paper notes, even where the scholarly paper laying out the UPP model explains the test's limitations, careful caveats are not fully replicated in the Guidelines.

For example, one key assumption underlying the UPP test – static competition – may not always hold. As the Carlton paper notes, "it is important for users [of the Guidelines] to understand that if the industry does not actually conform to the static Bertrand model, the result that positive UPP indexes for all products necessarily imply price increases for all products does not hold."[6] Like buyer self-protection, repositioning is another important, real-world response to any price increase, and although the Guidelines do acknowledge this possibility, they do so briefly and only at the end of a substantial exposition of the theory of liability, which assumes no repositioning and "[t]ak[es] as given other prices and product offerings."[7] Courts and other users of the Guidelines may misread this to suggest that repositioning analysis is a mere afterthought.

Relatedly, Section 6.1 of the Guidelines also states that "merger simulation methods need not rely on market definition." The agencies should be cautious about encouraging across-the-board departures from well-established case law in this area. Dispensing with market definition entirely could lead to unpredictable prosecutorial decisions in defining the relevant market for merger analysis, undermining the Guidelines' stated goal of increasing transparency. Moreover, as the companion Carlton paper explains, it may also lead courts astray and result in erroneous judicial decisions in merger cases.[8]

In short, the UPP test – particularly as articulated in Section 6.1 of the Guidelines – may chill procompetitive (or competitively neutral) deals. Including the UPP test in the Guidelines may encourage its use in mergers where it is of marginal, if any utility, while adding significant cost and time to the initial merger analysis and antitrust review process. Section 6.1 contains few of the limitations of the UPP test upon which it is built, and courts and other antitrust enforcers who are less expert at merger review may overread the test to promise certainty where it at best suggests possibilities.

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[4] *See* Dennis W. Carlton, *Comment on Department of Justice and Federal Trade Commission's Proposed Horizontal Merger Guidelines* (June 4, 2010).
[5] *City of New York v. Group Health, Inc.,* Civ. No. 06-13122 (S.D.N.Y. May 11, 2010).
[6] Carlton, *supra* note 4, at 15.
[7] Guidelines at 12.
[8] *See* Carlton, *supra* note 4, at 7.

It may be that the federal antitrust enforcement agencies will not enforce the UPP test in cases where it would be inappropriate, curing any overbreadth in the test through the exercise of sound prosecutorial discretion. Yet if the goal of the Guidelines is to be a transparent indicator of what the agencies will do – and to be a persuasive guide to courts as to how to review a merger for anticompetitive effects – then curing overbreadth through quiet prosecutorial discretion is no answer.

II. Section 2.2.1: Price and Marginal Cost

Section 2.2.1 of the Guidelines states that "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."[9] This could be misread to imply that prices that exceed marginal cost signal market power. They do not. As Deputy Assistant Attorney General Carl Shapiro has noted, "the competitive price can easily and significantly exceed marginal cost," particularly in innovative and other industries in which "[t]he gap between price and marginal cost provides a necessary return to cover various fixed costs."[10] Thus, "it is an error to infer genuine antitrust market power based on the gap between price and marginal cost."[11] As the companion Carlton paper notes, "in industries characterized by high levels of R&D and associated high fixed costs, as well as relatively low marginal costs, high short-run gross margins (price minus marginal cost) should not be presumed to demonstrate a lack of competition. Rather, there may be intense, dynamic competition to innovate and introduce new and improved products."[12] Indeed, in many of our industries, there often is a significant gap between price and marginal cost due to the presence of extraordinary fixed costs and relatively low marginal costs.

Similarly, the assertion in Section 2.2.1 that "a high purchase price may indicate that the acquiring firm is paying a premium to reduce competition or that the acquired firm has assets not easily replaced" does not account for other explanations for a high purchase price, particularly in industries with high fixed costs and in which the value of the acquired firm's investment in those fixed costs may have been substantial. Overlooking such circumstances in the competition analysis could be particularly damaging to smaller firms that rely heavily for financing on venture capital and private equity.

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[9] Guidelines at 4.
[10] Carl Shapiro, *Testimony Before Antitrust Modernization Commission* (Nov. 8, 2005) at 7, available at http://govinfo.library.unt.edu/amc/commission_hearings/pdf/Statement_Shapiro.pdf.
[11] *Id.*
[12] Carlton, *supra* note 4, at 10.

III. Section 10: Fixed-Cost Efficiencies and Innovation

In our 2009 Joint Submission, we urged the agencies to credit fixed cost efficiencies – particularly in R&D – in mergers in dynamic, high-tech industries.[13] Section 10 of the Guidelines now clarifies that the agencies "may consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market," and that fixed-cost efficiencies "can benefit customers in the longer run, e.g., if they make new product introduction less expensive."[14] The statement is an important step in the right direction, and we applaud the agencies for taking it.

Some of the caveats surrounding this statement, however, raise concerns. For example, the Guidelines state that the agencies "normally give the most weight to the results of this [efficiencies] analysis *over the short term"* and that "[d]elayed benefits from efficiencies (due to delay in the achievement of, or the realization of customer benefits from, the efficiencies) will be given less weight because they are less proximate and more difficult to predict."[15] Similar caveats are repeated in the text's discussion of efficiencies relating to research and development. For example, the Guidelines state that R&D cost savings "may be substantial and yet not be cognizable efficiencies because they are difficult to verify or result from anticompetitive reductions in innovative activities."[16] The Guidelines also seem to put aside the non-price benefits that innovation can provide. In stating that the agencies look for efficiencies that would reverse the potential anticompetitive effects of the merger, the Guidelines offer as an example efficiencies that would prevent "price increases," without noting the more substantial benefits that efficiencies stemming from innovation can provide.[17] Yet efficiencies that promote innovation can offer better products and services, advantages that far outstrip lowered prices on existing technology or lower prices in the future. Similarly, the Guidelines reflect a backward-looking approach, asserting that "efficiency claims substantiated by analogous *past experiences* are those most likely to be credited."[18]

These qualifying statements undermine the central point: that fixed-cost efficiencies – particularly stemming from R&D – can benefit customers in the long run, and that the agencies should take account of that in merger review. To be sure, all claimed efficiencies should be verified, but special skepticism should not be brought to bear on efficiencies that offer something other than traditional marginal cost reductions.

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[13] Biotechnology Industry Organization, The Financial Services Roundtable, Microsoft Corporation, The National Association Of Manufacturers & Verizon Communications Inc., *Joint Submission to the U.S. Department Of Justice And Federal Trade Commission for the Horizontal Merger Guidelines Review Project* (Nov. 2009), *available at* http://www.ftc.gov/os/comments/horizontalmergerguides/545095-00038.pdf.
[14] Guidelines at 30 n. 12.
[15] *Id.* (emphasis added). The earlier Guidelines contained similar statements. *See, e.g.,* DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES, Section 4, n. 37 (1992).
[16] Guidelines at 31; *see also id.* (stating that R&D efficiencies "are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions").
[17] *Id.* at 30.
[18] *Id.* at 30 (emphasis added).

Efficiencies that deliver short-term gains do not merit "the most weight"[19] just because more important efficiencies take more effort to verify.

We further note that the Guidelines may give a false impression about R&D efficiencies. By stating that substantial "[r]esearch and development cost savings" may not be cognizable "because they are difficult to verify or result from anticompetitive reductions in innovative activities,"[20] the Guidelines may be misread to imply that those are the only two possibilities. Yet R&D cost savings can lead to real efficiencies. The Guidelines should not be misunderstood to substitute careful, case-by-case analysis with any unintended assumption or presumption that a reduction in R&D efforts automatically equates with an "anticompetitive reduction in innovative activities."[21]

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In sum, we thank the agencies for offering this opportunity to comment on the agencies' draft revised Guidelines. We believe that the stakes here are high. The Guidelines are more than an articulation of how the federal antitrust agencies review mergers. The federal courts and other antitrust enforcement agencies, here and abroad, look to the Guidelines as the model for merger review. Overly broad Guidelines that condemn mergers on the basis of unilateral effects grounds too hastily, or that underestimate efficiencies drawn from innovation, thus have global ramifications. They cannot be cured through prudent DOJ or FTC decisions not to challenge an individual merger. Judges and antitrust officials worldwide look to the Guidelines alone for instructions on merger review. As a result, where the Guidelines are unclear or misguided, they risk chilling procompetitive mergers and injuring consumer welfare.

[19] *Id.* at 30 n.12.
[20] Guidelines at 31.
[21] *Id.*