Comments of James F. Rill, Jacqueline I. Grise, Christopher J. MacAvoy, Marc G. Schildkraut, and John M. Taladay (of Howrey LLP) and Dr. Oliver R. Grawe (of CapAnalysis Group, LLC) on Revised *Horizontal Merger Guidelines*[1]

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These comments are submitted in response to the request of the Department of Justice and the Federal Trade Commission ("the Agencies") for comments on the revised *Horizontal Merger Guidelines* ("draft *Guidelines*" or "draft *Merger Guidelines*") released April 20, 2010. The revisions raise many interesting issues, but our comments address only those we believe most important.

Section 4.1.2 – Benchmark Prices and SSNIP Size

Section 4.1.2 introduces the concept of "specific contribution" in a way that is not present in the current iteration of the *Guidelines*. While the current *Guidelines* state that "the price for which an increase will be postulated is considered to be the price of the product at the stage of the industry being examined," the draft *Guidelines* would replace the "price" of the product with the "value added" by the merging firms as the price base for purposes of analyzing a SSNIP.[2] The draft *Guidelines* appear to be addressing an anomaly that can arise in situations where the sales price of the product or service offered by the merging firms is not representative of the nature of competition. In so doing, however, the draft *Guidelines* merely replace one imperfect analytical tool with another. Such a change does not warrant the confusion it will create and, in any event, needs to be properly compartmentalized to reflect actual Agency practice.

The draft *Guidelines* indicate that the SSNIP percentage is to be applied to "… prices charged by firms in the candidate market *for the value they contribute* to the products or services used by customers."[3] The draft *Guidelines* then provide two examples, one involving an oil pipeline and one involving firms that install computers purchased from third parties.

As currently stated, the "specific contribution" concept in the draft *Guidelines* is a principle without limits and does not reflect current Agency practice. It is true that candidate markets *sometimes* are evaluated based on the "value added" by the merging firms – and indeed the oil pipeline example is an expanded version of the footnote 11 of the current *Merger Guidelines* – but the draft *Guidelines* far overstate the significance and frequency of use of this principle. For instance, if one were to consider the upstream suppliers of computers in Example

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1 These comments are not being submitted on behalf of any client of Howrey or CapAnalysis. The authors thank Donna J. Loop, Senior Regulatory Analyst in Howrey's Antitrust Practice Group, for her assistance.

2 Draft *Merger Guidelines* §1.11.

3 Draft *Guidelines* §4.1.2 (emphasis added).

8, arguably the principal competitive function of these computer manufacturers is to assemble components sourced from third parties. In a merger of computer manufacturers, however, the Agencies would not practically define the market as “computer component assemblers” and attempt to exclude the cost of components from the base upon which prices are assessed.[4] To follow the premise as it is stated in the draft *Guidelines* (and as expressed in Example 9) would suggest, carried to its logical extreme, that the benchmark price for a “product” could never be based on the selling price of the product unless the manufacturer was vertically integrated from raw material extraction through retail sales.

More fundamentally, however, as stated the “specific contribution” principle would prejudice firms that were not backwards-integrated into manufacturing or production, by permitting very limited scope for markets to be defined around finished products or SSNIPs to be based on final product prices. This effect would be exacerbated in markets involving mixed levels of integration. For example, imagine a market composed of 10 sellers of gadgets (a homogeneous product), 8 of which are vertically integrated from manufacture through final sales and two of which are independent sellers of the same products who purchase from other manufacturers that do not engage in final sales. Assume further that the two non-integrated firms seek to merge. According to the “specific contribution” principle as stated in the draft *Guidelines*, the SSNIP test in this case would be based solely on the “distribution” price of the gadget, despite the fact that the set of reasonably interchangeable competitive alternatives in the marketplace (i.e., the ultimate objective of the test) is far broader than indicated by the “specific contribution” test. Compared to a merger of two of the integrated players, this means that a smaller SSNIP percentage would be applied to the non-integrated firms, and it would be calculated on a smaller base. This could lead the merger to be viewed incorrectly as a “2 to 1” rather than a “10 to 9” transaction. This principle could also have anomalous effects in the opposite direction, where two firms that compete closely in practical terms – for instance highly specialized marketing channels for common products – could be deemed to reside in different relevant markets due to significant distinctions in their relative level of vertical integration, such that an actual “2 to 1” merger appeared more like a “10 to 9” transaction.

To be sure, a test based solely on sales price also has limitations, but at least benefits from clarity as to the base price for SSNIP analysis. Replacing the price test entirely with a value added test, which introduces significant complexity in analysis yet suffers from the same analytical frailties, is not an improvement. The draft *Guidelines* make clear that market definition is not to be conducted in a vacuum, but is to be assessed in conjunction with competitive dynamics. Thus, if the “value added” test is to be retained in the revised *Guidelines*, conditional language should at least be added to better explain the utility of this concept and to better describe its actual use by the Agencies. For example, the draft *Guidelines* could explain that specific contribution “is used where market dynamics indicate that competition among firms is based primarily upon the value that competing firms contribute to the product or service” in

4 *See, e.g.*, FTC Statement on Closing of HP-Compaq Merger Investigation: “The Commission conducted an extensive investigation of the merger's effect on competition in markets for personal computers, servers, and microprocessors, among other products.” FTC Press Release, March 6, 2002, *available at* http://www.ftc.gov/opa/2002/03/hpcompaq.shtm.

question.[5] They could explain that "this concept is utilized most frequently, but not exclusively, in service markets" and that "the extent to which the merging parties bear the risk of price changes in the selling price of the product" bears on the analysis. This would add to the explanatory purpose of the *Guidelines* and better reflect Agency practice.

Finally, Example 10 of the draft *Guidelines* is poorly worded and requires either modification or elimination. It states an assumption that the "*prices* paid" account for "95 percent of the firms' *revenues*." This confusingly equates "prices" with "costs" and must be corrected. Later, the example states that "significant competitive *effects* might well be *profitable*." Perhaps the term "possible" was meant to replace "profitable" but as written it is confusing in its misuse of terminology. If the purpose of the example is to illustrate that a lower percentage SSNIP generally will be used when the specific contribution can be clearly identified, then it should be clarified to make that point.

Section 4.1.3 – Implementing the Hypothetical Monopolist Test

Section 4.1.2 provides that the Agencies will consider "all of the evidence of customer substitution noted above in assessing the predicted loss" and "require that estimates of the predicted loss be consistent with that evidence, including the pre-merger margins of products in the candidate market." The draft *Guidelines* then posit that "[u]nless the firms are engaging in coordinated interaction (see Section 7), high pre-merger margins normally indicate that each firm's product individually faces demand that is not highly sensitive to price." Immediately following, the draft *Guidelines* conclude: "Higher pre-merger margins thus indicate a smaller predicted loss and make it more likely that the predicted loss is less than the critical loss.…"[6]

While theoretical models exist that are consistent with these statements, the real world support for this proposition is not sufficient for this concept to be incorporated in the *Guidelines*. High fixed cost industries must make high margins on products in order to survive and these high margins in no way imply that the firms in the industry are unduly profitable. For example, the costs in the development and sale of software are almost all fixed and thus the margins over variable costs are very large. Patents are a more extreme example of this phenomenon. Surely, though, the Agencies do not believe that all software developers and all patent holders are either engaged in coordinated interaction or have some degree of monopoly power. To the extent patent holders are not colluding, the draft implies that patents (if they have been licensed) are monopolies or near monopolies. But this is inconsistent with the conclusions of the *Intellectual Property Guidelines* that individual patents do not necessarily constitute individual product markets.[7]

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5 Note that the term "competing firms" may be preferable to "merging firms" in this context given that the merging firms may not be characteristic of the marketplace, as evidenced in the "gadget" example above.

6 The draft *Guidelines*' use of the adjectives "high" and "higher" injects troubling ambiguity into the analysis. No guidance is provided as to what levels of margins the Agencies would consider "high."

7 U.S. DEP'T OF JUSTICE & FEDERAL TRADE COMM'N, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY (1995).

Respectfully, we think it would be inappropriate for the *Guidelines* to bias critical loss analysis by insisting that high margins mean a low degree of substitution. The Agencies should consider all of the available real world evidence on the degree of substitution in their analyses.

Section 6 – Unilateral Effects

Section 6 of the draft *Guidelines* discusses unilateral effects but provides insufficient guidance. Section 6 uses the adjectives "substantial" and "significant" but does not say what these words mean in this context. This contrasts with the use of the word "significant" in the market definition discussion, where the draft *Guidelines* define a small but significant and non-transitory increase in price (SSNIP). This may (or may not) result in a dramatic difference in enforcement covering coordinated interaction versus unilateral effects.

As written, the draft *Guidelines* seem to ensure there will be more enforcement against unilateral effects than against coordinated effects. Section 6.1 states: "[d]iagnosing unilateral price effects based on the value of diverted sales need not rely on market definition or the calculation of market shares." If the intent were to abandon market definition, low market concentration would provide no safe harbor where unilateral effects are at issue. To illustrate the point, assume a "market" (defined as one would define a market under Section 4 of the draft) with ten equal firms, equal substitution among the products of the firms and a market elasticity of -1. We apply the upward pricing pressure ("UPP") analysis set forth in Section 6.1 to a merger of any two of the firms would predict a price increase of *more than* five percent for pre-merger margins greater than 40%.[8] But the HHI is well below 1500, meaning that the merger would be in the safe harbor at least for coordinated effects. For unilateral effects, there may be no safe harbor. One might counter that the Agencies ought to challenge a coordinated effects merger where the predicted price increase is more than five percent even if the market is unconcentrated. Indeed, Section 4.1.1 of the draft says the SSNIP test is not a tolerance level for a price increase. But if the SSNIP test means anything, it means that the Agencies will not investigate mergers that result in a post-acquisition HHI of less than 1500. Do the Agencies mean to suggest that they will devote their resources to analyzing closely the unilateral effects of 10-to-9 mergers?

An alternative point of view is that markets must be defined at some point. Section 4 states: "The Agencies' analysis need not start with market definition. Some of the analytical tools used by the Agencies to assess competitive effects do not rely on market definition, although *evaluation of competitive alternatives available to customers is always necessary* at some point in the analysis" (emphasis added). If the intent here is to say that a market must be defined at some point, then perhaps the Agencies would not challenge the merger we hypothesized above. But an equally plausible interpretation of the quoted statement in Section 4 is that the Agencies will not necessarily return to market definition. Rather, they will analyze competitive alternatives in some unstated manner.

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8 Following Joseph Farrell & Carl Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition* (Dec. 2008), *available at* http://faculty.haas.berkeley.edu/shapiro/alternative.pdf.

Another perspective is that the UPP analysis can itself define a product market. Suppose that we use the five percent SSNIP rather than the ten percent SSNIP because of the characteristics of the market. Our 10-to-9 hypothetical resulted in a unilateral price increase of more than five percent. Does this mean the products of the two merging firms are a market, despite the fact that eight other firms have equally substitutable products? Section 4.1.1 states: "[w]hen applying the hypothetical monopolist test to define a market around a product offered by one of the merging firms, if the market includes a second product, the Agencies will normally also include a third product if that third product is a closer substitute for the first product than is the second product." In our hypothetical, will the Agencies include the other eight equally substitutable products in the market or will they conclude that the two products are a market despite the substitution of the other eight products?

This discussion leads us to several recommendations. First, the Agencies should employ the standard market definition test in unilateral effects analysis. At minimum, all products that are equally substitutable or more substitutable than the merging firms products would have to be included in the market. If after this process, the merger generates post-acquisition HHIs in the safe harbor, the Agencies would not challenge the merger barring circumstances more special than those suggested here. Second, the Agencies should apply the SSNIP test to define "significance" in unilateral effects analysis. That is, if the UPP test suggests a price increase of less than five or ten percent, the merger also would be in the safe harbor as far as unilateral effects analysis is concerned.

We believe such safe harbors offer much more guidance to practitioners than the present draft. Under the present draft, any merger involving two differentiated products that were in the least substitutable would result in some upward pricing pressure. Because there is no way of knowing whether that price increase is "significant" or "substantial," there is no way to advise clients as to whether the Agencies would challenge the merger.

Of course, other evidence can undermine the UPP test. We recommend that the Agencies clarify that this is the case. We think it is fairly clear that the types of evidence set out in Section 2.1 can trump UPP analysis. But we think it is useful nevertheless to at least offer a cross reference in the unilateral effects section to the types of evidence set out in Section 2.11. A full discussion of trumping evidence would be even more helpful. The UPP test is a theoretical test; it predicts a price increase based on the degree of substitution between merging products. The types of evidence set out in Section 2.1 can offer a real world refutation to the UPP test. Direct comparisons based on experience ought to count for more than a UPP test.

As we discussed in the preceding section of these comments, the draft *Guidelines* incorporate a bias against high fixed cost industries. The bias stems from the treatment of critical loss and high margins, as discussed above, as well as from the UPP test, which we now address. Here we note that the UPP test is biased against industries with high fixed costs and low variable costs, such as high technology industries. For any given diversion ratio, the higher the margin, the greater is the upward pricing pressure. So, for example, the combination of two patents with margins of 97.5 percent (because there are almost no variable costs to licensing patents) with only a one percent diversion ratio—they are barely substitutable—results in a price increase of 65 percent.[9] As the margins climb from 97.5 percent to 99 percent, the predicted upward pricing pressure becomes stratospheric. That is, the Agencies would challenge a merger of any patents, software, or high margin products where perhaps only one out of one hundred customers or licensees would consider them substitutes. The stratospheric nature of the price increases suggests to us that the Agencies are giving UPP an unduly large role in merger analysis, as we have never seen post-merger price increases on the order of magnitude predicted by the UPP test. At minimum, it suggests the need for another *de minimis* standard, requiring a diversion ratio of at least 10 percent between the merging products.

Section 5.3 – Presumptions

In Section 5.3, the draft *Guidelines* set out the level of Agency scrutiny that a merger can expect based on post-acquisition levels of concentration. We focus here on the presumption that an acquisition would lessen competition if the post-acquisition market is highly concentrated (an HHI of 2500) and the change in the HHI is greater than 200. This presumption can be rebutted by persuasive evidence, according to the draft. It is not clear what the presumption means, however, because the next paragraph in Section 5.3 states:

> The purpose of these thresholds is not to provide a rigid screen to separate acceptable mergers from anticompetitive transactions …. Rather, they provide one way to identify those mergers for which it is particularly important to examine whether other competitive factors confirm, reinforce, or would counteract the potentially harmful effects of increased concentration.

If the threshold is breached, does this reverse the burden of proof, or does it simply identify the merger as one that is particularly important to examine?

We believe that a reversal of the burden of proof is not consistent with present practice. Under present practice, a post-acquisition HHI of 2500 with a change of 200 is not taken to mean that the *parties* must prove easy entry conditions or that coordinated interaction is implausible. While such a merger will be subject to heavy scrutiny, under current practice the investigating Agency must still convince itself that entry is difficult and that enhanced post-acquisition coordinated is quite plausible. The draft *Guidelines*' presumption implies a rigidity in the analysis and a predictive precision in the HHIs that are beyond the present level of economic knowledge.

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9 The diversion-ratio-driven formula for estimating merger-induced price increases with symmetric margins and diversion ratios is mD/(1 –m –D), where m denotes the margin, and D denotes the diversion ratio. *See* Carl Shapiro, *Mergers With Differentiated Products*, Nov. 9, 1995, *available at* http://www.justice.gov/atr/public/speeches/shapiro.spc.htm).

Sections 5.1 and 9 – Entry

The draft *Guidelines* make changes in the 1992 *Guidelines* language in both the entry section and the introduction of the concept of "rapid entrants." § 5.1, § 9. In doing so, the draft sacrifices some of the clarity and analysis contained in the current *Guidelines* provisions relating to supply response. We question the basis for the draft *Guidelines*' elimination of the one-year entry-time limitation to inclusion of a firm in the definition of a rapid entrant/supply responder. We also question the elimination of the condition that a rapid entrant/supply responder must be able to enter the market with low sunk costs; *e.g.*, generally recoverable within a year at a SSNIP level. *See* 1992 *Guidelines*, § 1.32. These elements provide greater certainty to the analysis and additional limitations to distinguish between rapid entrants and entrants treated under Section 9 of the draft *Guidelines*. The distinction is particularly important in light of the different analytical treatment accorded each type of entrant under both the 1992 *Guidelines* and the current draft *Guidelines*.

In addition, it is not clear that there is a basis for considering a firm which is capable of repositioning to defeat a unilateral, merger-induced price increase under the committed entry rubric as set forth in Section 6.1 of the draft *Guidelines*. If such repositioning is likely and could be accomplished with low sunk costs, as identified in Section 1.32 of the 1992 *Guidelines*, it seems more appropriate to include the repositioning firms in the relevant market on the same basis as other "rapid" entrants.

Section 9 of the draft *Guidelines*, dealing with committed entry, introduces concepts that suggest a more restrictive approach than that applicable under existing law and practice. There does not appear to be any basis for the requirement that entry be "sufficient to replicate at least the scope and strength of one of the merging firms." Section 9.3. The appropriate question is whether entry will be sufficient to deter a merger-induced price increase, which could well be the case whether or not the entrant would replicate the scope and strength of one of the merging parties. We suggest the limiting sentence be deleted.

The rationale for the deletion of the condition that entry have market impact generally within a two-year time frame is unclear and we suggest it be restored. The condition sets an outside limit, in most cases, for entry to be a relevant consideration, not a tolerance level for a period of price increases. If the prospect of significant market impact within a two-year time frame is apparent, that prospect would ordinarily be sufficient to deter any short-sighted, merger-induced price elevation. In addition, it is unclear why the draft *Guidelines* eliminate the caveat with respect to durable goods, which seems an appropriate modifier of the two-year time frame.

Section 12 – Mergers of Competing Buyers

A new section discusses the analysis of mergers of competing buyers. The new section risks confusing rather than clarifying this area. Curiously, this was not among the topics on which the Agencies initially solicited public input. The new section indicates that the Agencies may challenge mergers that harm sellers in the upstream (or "buying side") market even if there is no injury to consumers in the downstream market. This statement is not without controversy. Writing in 2006, for example, Commissioner Rosch argued that the proper focus in a monopsony case should be on price and quantity effects in the output: "To me, 'consumer welfare' means just that – the welfare of those who are confronted by actual or threatened exercises of seller market power in the output market. I think that view of 'consumer welfare' generally – and the way the antitrust laws apply to an exercise of monopsony power specifically – are consistent with the Guidelines adopted by both the DOJ and the FTC."[10] Others have questioned whether merger enforcement should be concerned with mere wealth transfers between upstream sellers and buyers in the absence of harm to consumers.[11]

It is perhaps not coincidental that the Department of Justice currently is holding, in cooperation with the Department of Agriculture, a series of public workshops devoted to the interface of antitrust and agriculture. The workshops are being conducted against a background of complaints by farmers, ranchers, and allied interests that the antitrust Agencies have been too lenient in their approach to mergers in the sector. A commonly voiced complaint in recent years has been that "power buyers" are paying farmers too little for their inputs. Whether this is true, and whether there has also been harm to consumers, is a much debated point.

Of course, a merger that creates a larger buyer may or may not harm consumer welfare. It has been observed that:

> [i]nput prices can fall for two entirely different reasons, one of which arises from a true economic efficiency that will tend to result in lower prices for final consumers. The other, in contrast, represents an efficiency-reducing exercise of market power that will reduce economic welfare, lower prices for suppliers, and may well result in higher prices charged to final consumers. Antitrust must distinguish these two situations and pursue enforcement against the latter, but not the former.[12]

There is broad support for the proposition that monopsony raises competitive concerns only in circumstances where buyers can depress input prices *and* thereby reduce the quantity of inputs purchased below competitive levels. Thus, in *Caremark/Advance PCS,*[13] the FTC declined to challenge a merger of two large pharmacy benefits management (PBM) companies,

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[10] J. Thomas Rosch, Commissioner, Federal Trade Commission, "Monopsony and The Meaning of 'Consumer Welfare' – A Closer Look at *Weyerhaeuser*," before the 2006 Milton Handler Annual Antitrust Review, Dec. 7, 2006, at 7 (footnote omitted). For a contrary view, see Gregory J. Werden, *Monopsony and the Sherman Act: Consumer Welfare in a New Light*, 74 ANTITRUST L.J. 707, 735 (2007) ("Neither the legislative history of the Sherman Act nor the decisions of the Supreme Court and courts of appeals in applying the Act support a narrow notion of consumer welfare, such as end-user welfare. Rather, the Sherman Act was intended to protect, and does protect, sellers victimized by cartelization or monopsonization."). Writing in 2006, Commissioner Rosch noted that in all but one of the Agencies' recent merger complaints involving monopsony issues, there were also allegations of anticompetitive effects in the output market. "The one exception was *United States v. Cargill,* however Congressional concerns over farmers may have driven that decision." Rosch, *supra*, at 9-10 n.20.

[11] *See* Rosch, *supra,* at 5 n.12.

[12] R. Hewitt Pate, Ass't Attorney General, Antitrust Division, Statement Before the Committee on the Judiciary of the United States Senate Concerning Antitrust Enforcement in the Agricultural Marketplace (Oct. 30, 2003), at 3.

[13] Caremark Rx, Inc./Advance PCS, FTC File No. 031 0239 (Feb. 11, 2004), *available at* http://www.ftc.gov/os/caselist/0310239/0310239.htm.

despite concerns it would lead to lower dispensing fees paid to pharmacies. The Commission explained that competition and consumers are not harmed "when the increased bargaining power of large buyers allows them to obtain lower input prices without decreasing overall input purchases."[14] The Commission found that "[i]n the present case, there is no reason to expect a monopsony or oligopsony outcome – *i.e.*, one in which overall purchases from pharmacies are reduced – even if the acquisition enables the merged PBM (or PBMs as a group) to reduce the dispensing fees they pay to retail pharmacies."[15] The Agencies also acknowledged this point in the *Competitor Collaborations Guidelines*, which define monopsony as "the ability or incentive to drive the price of the purchased product, and thereby *depress output*, below what likely would prevail in the absence of the relevant agreement."[16] Similarly, in *Weyerhaeuser* the Supreme Court described a monopsonist as one who seeks to "restrict its input purchases below the competitive level, thus reduc[ing] the unit price."[17]

If the *Merger Guidelines* are to contain a new section describing the analysis of mergers of competing buyers, it should explicitly state that monopsony is of concern only if the merger will allow the merged firm to drive down input prices *and* reduce the quantity of inputs supplied. In addition, the discussion should provide clear guidance on how to distinguish procompetitive effects (efficiencies) of buying power from anticompetitive effects. The present draft, however, offers no means of distinguishing an efficient reduction in prices from an anticompetitive reduction in prices. One would have thought that a reduction in prices would be deemed efficient if it resulted in increased output and lower downstream prices, yet the draft *Guidelines* assert that the quantity purchased and the prices in downstream markets are not "the only, or best" indicia of enhanced buyer power. This leaves one adrift as to how to distinguish between efficiencies and anticompetitive effects on the buying side.

Finally, there is a perceptible but unexplained contradiction in the draft *Guidelines*' tough treatment of potential buyer power and the more tolerant approach to buyer power in the Agencies' 2007 *Intellectual Property Report* ("*IP Report*").[18] The *IP Report* prescribes rule of reason treatment for *ex ante* negotiations of licensing terms, citing "the strong potential for procompetitive benefits."[19] The examples offered in the *IP Report* of situations that would pose competitive problems under the rule of reason are quite limited. This attitude appears to be at odds with the draft *Merger Guidelines'* suggestion that driving down the price obtained by the seller is, by itself, grounds for intervention. A conceptually more unified approach is needed. Accordingly, the *Merger Guidelines* should mirror the accepted analysis of monopsony and

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14 *Id.*

15 *Id.*

16 U.S. DEP'T OF JUSTICE & FEDERAL TRADE COMM'N, ANTITRUST GUIDELINES FOR COLLABORATIONS AMONG COMPETITORS § 3.31(a) (2000) (emphasis added).

17 Weyerhaeuser Co. v. Ross-Simmons Hardware Lumber Co., 549 U.S. 312, 320-21 (2007) (quoting Steven C. Salop, *Anticompetitive Overbuying by Power Buyers*, 72 ANTITRUST L. J. 669, 672 (2005)).

18 U.S. DEP'T OF JUSTICE & FEDERAL TRADE COMM'N, ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION (2007).

19 *Id.* at 49-56.

should affirmatively state that a predicted reduction in prices paid to upstream suppliers will only be grounds for competitive concern if it is accompanied by a predicted reduction in output and a concomitant increase in downstream prices.