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To: Federal Trade Commission and Department of Justice Merger

From: William Vigdor

Re: Horizontal Merger Guidelines Review Project: Proposed New Horizontal Merger Guidelines

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Introduction

We want to thank the Federal Trade Commission and Antitrust Division of the Department of Justice (individually "Agency" and collectively the "Agencies") for taking the unprecedented step of accepting for public comment the draft Guidelines issued on April 20, 2010 (the "Draft Guidelines"). We believe these Guidelines are an excellent description of the Agency practice and provide useful guidance. We believe the Draft Guidelines can be improved incrementally and offer the following suggestions. The suggestions made below do not represent the views of my firm or any client.

Comments on Structural Aspects of the Draft Guidelines

The Draft Guidelines reflect an ambitious and helpful effort on the part of the Agencies to provide guidance as to how they will review a merger and at the same time explain the various approaches and tools the Agencies use to evaluate a merger. The Draft Guidelines appear to lie on a continuum between the 1992 Horizontal Merger Guidelines (revised in 1997) (the "Existing Guidelines"), which provides a method for analyzing mergers,[1] and the Federal Trade Commission and Department of Justice Commentary on the Horizontal Merger Guidelines 2006 (the "Merger Commentary")[2], which explains how the Agencies apply the Existing Guidelines. While the Draft Guidelines appear to reflect the fact-specific, non-structured Agency approach to merger analysis, which is extremely helpful to the public,

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[1] U.S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, 1992 (revised 1997), *available at* http://www.usdoj.gov/atr/public/guidelines/hmg.htm.

[2] U.S. Department of Justice and the Federal Trade Commission, *Commentary on the Horizontal Merger Guidelines*, 2006, *available at* http://www.usdoj.gov/atr/public/guidelines/215247.htm.

as drafted, they provide less guidance then they otherwise could provide.[3] Accordingly, we believe that the Agencies can increase the utility of and guidance provided by the Draft Guidelines by incorporating additional examples or citing to the applicable sections of the Merger Commentary to exemplify how the Agency applies the principles and tools described in the Draft Guidelines. Such cross references also enhances the value of the Merger Commentary. In particular, we believe that the following sections would benefit greatly from additional examples and/or cross references to the Merger Commentary:

Section 2.1.2 Direct Comparisons Based on Experience
Section 2.1.4 Substantial Head-to-Head Competition
Section 2.1.5 Disruptive Role of a Merging Party
Section 6.2 Bargaining and Auctions
Section 6.3 Capacity and Output for Homogeneous Products
Section 6.4 Innovation and Product Variety
Section 7.1 Impact of Merger on Coordinated Interaction
Section 7.2 Evidence a Market is Vulnerable to Coordinated Conduct
Section 9 Entry
Section 11 Efficiencies
Section 13 Partial Acquisitions

Many sections of the Draft Guidelines explain when markets may be defined narrowly or when the facts suggest a merger is anticompetitive. We believe examples showing the evidence that persuades the Agencies to define markets broadly and narrowly, and evidence of both pro- and anti-competitive effects of a merger would improve the Draft Guidelines.

Comments on Section 2: The Role of Economic Modeling

Section 2 usefully describes the types and sources of evidence that the Agencies consider when determining whether a merger may lessen competition substantially.[4] Other than a vague reference to Section 6 (unilateral effects), Section 2 does not discuss the role of economic modeling as a type and source of evidence of that is among the "most

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[3] We are mindful that no set of guidelines can explain all the ways in which a merger may be analyzed, and that final guidelines should not unduly restrict the ability of the Agencies to use all reasonably available and reliable evidence in and probative tools for analyzing a merger.

[4] *See* Draft Guidelines § 2 ("The Agencies consider any reasonably available and reliable evidence to address the central question of whether a merger may substantially lessen competition. This section discusses several categories and sources of evidence that the Agencies, in their experience, have found most informative in predicting the likely competitive effects of mergers.").

informative." Section 6.1 (pricing of differentiated products) indicates that formal models "may" be used to evaluate the competitive effects of mergers.[5] We also note that several other competitive effects sections make no mention of any formal modeling.[6] In addition, Section 6.1 states that "[t]he Agencies do not treat merger simulation evidence as conclusive in itself …." In short, we believe that the Draft Guidelines would benefit if Section 2 and the competitive effects sections clarified the extent to which economic modeling (including statistical analysis, econometric estimation, and merger simulation) is used by the Agencies as a source of evidence, and how much weight the Agencies give to economic modeling evidence, in particular when such evidence happens to be inconsistent with other types of evidence described in Section 2.

Such a discussion would be extremely helpful to the business community because the Agencies' requests for information call for a good deal of data that typically costs hundreds of thousands of dollars to collect, format and submit to the Agencies. We thus urge the Agencies to expound further on the role of formal economic modeling and data analysis in the Draft Guidelines.

Comments on Section 3: Targeted Customers and Price Discrimination

The Agencies' expanded discussion on the treatment of targeted customers is quite helpful.[7] The discussions on this issue would be further improved if the Agencies could explain in more detail how the Agencies evaluate a situation where a group of targeted customers would suffer from an exercise of market power, but that group of customers would not constitute a well-defined market under Section 4 of the Draft Guidelines. More particularly, under what circumstances would the Agencies challenge a transaction having an anticompetitive effect for targeted customers where the hypothetical monopolist would not profitably raise price to those customers by a SSNIP?

In addition, the Draft Guidelines do not explain whether there is a minimum size of the targeted class of customers. More particularly, the Guidelines do not identify a threshold

[5] *E.g.*, *id.* § 6.1 ("In some cases, the Agencies may seek to quantify the extent of direct competition between a product sold by one merging firm and a second product sold by the other merging firm by estimating the diversion ratio from the first product to the second product"); *id*. ("Where sufficient data are available, the Agencies may construct economic models designed to quantify the unilateral price effects resulting from the merger.").

[6] *E.g.*, *id.* §§ 6.2, 6.3, 6.4.

[7] *Id*. §§ 3 (Targeted Customers and Price Discrimination), 4.1.4 (Product Market Definition with Targeted Customers), 4.2.2 (Geographic Markets Based on the Locations of Customers).

below which the size of the targeted group of customers would not be of concern to the Agencies. It would therefore be helpful for the Draft Guidelines to discuss whether there can be a customer class that is too small to be of concern.

Comments on Section 4: Market Definition

A key analytical construct for defining markets involves analyzing whether a hypothetical monopolist would find it profitable to impose at least a small but significant and non-transitory increase in price ("SSNIP").[8] The Agencies have generally applied a SSNIP of 5% above prevailing prices, although there are a number of industries in which the Agencies have applied smaller a SSNIP (*e.g.*, 1 cent per gallon in gasoline marketing; 1% in grocery retailing; ½ cent per gallon in gasoline terminal services). The Draft Guidelines propose as a general rule to apply a 10% SSNIP above prevailing prices of the products or services supplied by the firms in the putative market. They also discuss considerations that might lead to the use of SSNIP thresholds smaller than 10%. We believe the Draft Guidelines would benefit from a description of the industries in which the Agencies will typically use a SSNIP below 10%. In addition, it would be helpful for the Draft Guidelines to explain more precisely which aspects of an industry causes the Agencies to use a SSNIP below 10%.

Missing from the market definition test described in both the Draft Guidelines and the Existing Guidelines is the speed with which customers must switch to "outside goods" to make a price increase unprofitable. We suggest that the Agency discuss the time from within which customers may switch to satisfy the hypothetical monopolist test.

Comments on the Use of Margins in Sections 2.2.1 and 4.1.3

The Agencies indicate 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] The Draft Guidelines also state that:

> Unless 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. Higher pre-merger margins

[8] *Id.* § 4.1.1 ("Specifically, the test requires that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future seller of those products ("hypothetical monopolist") likely would impose at least a small but significant and non-transitory increase in price ('SSNIP') on at least one product in the market, including at least one product sold by one of the merging firms.").

[9] *Id.* § 2.2.1.

> thus indicate a smaller predicted loss and make it more likely that the predicted loss is less than the critical loss and that the candidate market satisfies the hypothetical monopolist test.[10]

While there is likely to be a great deal of discussion and disagreement about the propriety of using "high margins" to infer coordination or inelastic demand,[11] we do believe that the Draft Guidelines would further assist the business community by articulating how the Agencies determine the threshold for identifying margins that are high and warrant the inferences of coordination and inelastic demand.

Comments on Section 6: Unilateral Effects

We believe the discussion of unilateral effects in the Draft Guidelines is a significant improvement relative to the Existing Guidelines. One noticeable omission is that the Draft Guidelines do not discuss the 35% proviso in the Existing Guidelines. Thus, a merger of two firms with a small share of the market, say 5% each, could theoretically be found to reduce competition if they are close substitutes to one another. We believe it would be helpful for the Agencies to explain in more detail why the 35% test has been eliminated and why it has not been replaced with a different test.

Comments on Section 7: Coordinated Effects

In Section 7.1, the Draft Guidelines state that "[t]he Agencies are likely to challenge a merger that would significantly increase concentration and lead to a moderately or highly concentrated market if that market shows signs of vulnerability to coordinated conduct and the Agencies have a theory they deem plausible of how the merger may cause adverse coordinated effects." Section 7.2 explains how the Agencies assess whether the market is "vulnerable" to coordinated conduct. The Agencies do not, however, describe or provide examples of the theories that the Agencies might deem plausible for assessing potential coordinated effects. The discussion in Section 7.2 seems to refer implicitly to models of tacit collusion and other interdependent behavior. A more explicit discussion would provide the business community with more helpful guidance.

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[10] *Id*. § 4.1.3.

[11] We believe that while there are circumstances that high margins may indicate coordination exists or that demand is inelastic, we believe there are other circumstances where inferring coordination and inelastic demand from high margins is warranted. We therefore believe that the inference to be drawn from margin data is an empirical question, the answer to which depends on the shape of the supply and demand functions, the cost structure of the industry and other factors.

Comments to Section 9: Entry

In various sections of the Draft Guidelines, the Agencies indicate that potential entry, expansion or repositioning are relevant considerations provided they could occur "rapidly."[12] In the Existing Guidelines, 1-year uncommitted entry and 2-year entry are the standards. The Draft Guidelines could provide valuable guidance by explaining, as do the Existing Guidelines, the timelines being applied by the Agencies.

Comments on Section 10: Efficiencies

We applaud the Agencies for explaining how "merger-generated efficiencies may enhance competition."[13] We also believe it is quite helpful that the efficiencies discussion references the competitive effects sections.[14] We suggest that rather than segregating the efficiencies discussion from the competitive effects sections, the Agencies fold the efficiencies discussion into each of Sections 6 (unilateral effects) and 7 (coordinated effects). We believe this approach would be consistent with the approach the Agencies are taking with respect to the role of market shares in the competitive effects Section. The Draft Guidelines view shares as a part of the effects analysis and not a separate element. In our experience, the Agencies also consider efficiencies to be a part of the competitive effects analysis. We therefore suggest that the efficiencies be addressed in subsections of the competitive effects sections.

We also suggest that the Draft Guidelines expand the discussion and address the treatment of fixed cost savings, particularly in industries with high margins and high fixed costs. Reduced fixed costs can spur investment and capacity expansion, which is precompetitive.

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[12] *Id*. §§ 2.1.5 (disruptive firm), 5.1 (market participant), 7 (coordinated effects), 9 (entry).

[13] *Id*. § 10 ("[A] primary benefit of mergers to the economy is their potential to generate significant efficiencies and thus enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products.").

[14] *Id*. ("In a unilateral effects context, marginal cost reductions may reduce or reverse any increases in the merged firm's incentive to elevate price. Efficiencies also may lead to new or improved products, even if they do not immediately and directly affect price. In a coordinated effects context, marginal cost reductions may make coordination less likely or effective by enhancing the incentive of a maverick to lower price or by creating a new maverick firm.").

Conclusion

As indicated above, we appreciate the Agencies issuing the Draft Guidelines to reflect their current enforcement practices. We believe the Draft Guidelines are quite helpful but can be improved by incorporating the suggestions above. We thank you for your consideration.