HMG Review Project—Comment, Project No. P092900

Comments of Philip B. Nelson[1]

Introduction

My comments focus on a number of improvements that might be made to more accurately describe Agency practice or improve the merger review process. They do not reflect a comprehensive review of the *Guidelines*,[2] focusing instead on a number of specific points that have caught my attention when I have worked on mergers. More specifically, my comments address portions of the following questions: Questions #3, #6, #7, #8, and #9.[3]

Question #3: Hypothetical-Monopolist Test

- ***The Guidelines should clarify what the Agencies do when pre-merger market power has led "prevailing" prices to be above the competitive level.***
    - The *Guidelines* indicate that mergers may be problematical when they "create," "enhance" or "facilitate" the exercise of market power. (*Guidelines*, §01; see also *Commentary* at 1.[4])
    - However, one can also categorize the potential anticompetitive effects of mergers by looking at whether mergers lead to a post-merger increase in prices or whether they entrench a firm or group of firms with pre-existing market power (which I will refer to as horizontal entrenchment).[5]

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[2] Department of Justice and Federal Trade Commission, *1997 Horizontal Merger Guidelines* (hereinafter *Guidelines*).

[3] While I have done a lot of work on failing firms (starting with my doctoral dissertation), I will not address Question #17 (which relates to "Failure and Exiting Assets") here, since a coauthor of mine (Henry McFarland) is providing comments on this question that reflect my thoughts. However, please see the following publications for additional thoughts on this topic: Philip Nelson, CORPORATIONS IN CRISIS: BEHAVIORAL OBSERVATIONS FOR BANKRUPTCY POLICY, (1981) and Henry McFarland and Philip Nelson, *Failing Firms and Declining Industries*, American Bar Association Antitrust Section's ISSUES IN COMPETITION LAW AND POLICY (2008).

[4] U.S. Department of Justice and Federal Trade Commission, *Commentary on the Merger Guidelines* (2006) (available at http://ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf.). [Hereinafter, *Commentary*]

[5] Two types of "entrenchment" should be distinguished. My discussion focuses on "horizontal entrenchment," which should be distinguished from "conglomerate entrenchment." For example, I refer to

- Horizontal entrenchment and post-merger price increases may arise in either unilateral effects or coordinated effects cases.[6]

- An important issue is whether a market defined using elasticities at "prevailing,"[7] pre-merger prices will allow the Agencies (and courts) to accurately assess the competitive effects of a merger, regardless of whether they are exploring a "price increase" or "horizontal entrenchment" theory.

- As is well-recognized in the literature that discusses the famous "cellophane fallacy,"[8] when a firm (or group of firms) has market power that has been used to increase prices above the competitive level, a firm's market power may not be recognized if one defines the relevant market by measuring elasticities at the prevailing monopoly prices since historical monopolization may have increased prices to a point where there are numerous substitutes (even though there are no close substitutes at the lower competitive price). Only by measuring elasticities at competitive prices will one be able to identify market

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a dominant firm's acquisition of a fringe competitor or potential entrant as "horizontal entrenchment." Similarly, a merger that solidifies the ability of a collusive group to sustain monopolistic pricing is a type of "horizontal entrenchment." Commentators and courts have been concerned about horizontal entrenchment. (See e.g., Phillip Areeda, Herbert Hovenkamp, and John Solow, ANTITRUST LAW, Volume IV (1998, revised edition) at 56 ("The acquisition by an already dominant firm of a new or nascent rival can be just as anticompetitive as a merger to monopoly. . . . Acquisition of such a rival preserves the dominant firm's status. . . The important point is that the acquisition eliminates an important route by which competition could have increased in the immediate future. It thus bears a very strong presumption of illegality that should rarely be defeated.") Courts have expressed concerns (even in the context of Sherman Act Section 2 cases) about conduct that "reasonably appear[s] capable of making a significant contribution to . . . maintaining monopoly power" (*United States v. Microsoft* 253 F. 3d 34 (D. C. Cir.), cert. denied, 122 S. Ct. 350 (2001) at 79.), as the acquisition of a fringe competitor by a dominant firm might do.

The horizontal entrenchment on which I'm focusing differs from the more controversial "conglomerate entrenchment" that was the focus of some earlier U.S. merger cases, such as *FTC v. Procter &Gamble Co*., where the concern was that "the substitution of the powerful acquiring firm for the smaller, but already dominant, firm may substantially reduce the competitive structure of the industry by raising entry barriers and by dissuading the smaller firms from aggressively competing." (*FTC v. Procter &Gamble Co*. 386 U.S. 568, 578 (1967)) For a critical discussion of conglomerate entrenchment theory, see e.g., Department of Justice, Antitrust Division Submission for OECD Roundtable on Portfolio Effects in Conglomerate Mergers, *Range Effects: The United States Perspective*, (2001) available at http://www.justice.gov/atr/public/international/9550.htm.

[6] Both a dominant firm and a collusive group may find it profitable to raise prices after a merger because the merger eliminates a competitive force that was constraining prices. Both dominant firms and collusive groups may be entrenched by a merger. A dominant firm's monopolistic position may be entrenched if a merger eliminates a fringe competitor or a potential entrant. A collusive group may have its market power entrenched if the merger eliminates a maverick or other competitor that may periodically disrupt the anticompetitive coordination.

[7] See *Guidelines*, §1.11.

[8] For a discussion of the cellophane fallacy that I provided in earlier hearings, see: http://www.justice.gov/atr/public/hearings/single_firm/docs/222008.htm.

power—that is determine if a firm (or group of firms) will be able profitably to maintain prices above competitive levels for a significant period of time.

- Most of the *Guidelines*' discussion of market definition assumes that the analysis will employ current ("prevailing") prices when evaluating the elasticities that are relevant to market definition. While this is clearly correct when the market power is not being exploited before the merger, it is not clear that this is appropriate if the exploitation of market power has led prices to rise above competitive levels before the merger.

- The current *Guidelines* reflects some concern about the cellophane fallacy when it states: "In the above analysis, the Agency will use prevailing prices of the products of the merging firms and possible substitutes for such products, unless premerger circumstances are strongly suggestive of *coordinated interaction*, in which case the Agency will use a price more reflective of competitive prices." (*Guidelines*, §1.11, emphasis added) While this statement suggests that the Agencies recognize that potential analytic mistakes may be made if prevailing prices are used to define the relevant market when those prices are above competitive levels, it doesn't elaborate on exactly when competitive prices will be used instead of current prices. Moreover, it does not mention the possibility that the Agencies may measure elasticities at competitive prices when they are considering unilateral effects theories since it focuses exclusively on coordinated effects theories.

- There appears to be no obvious reason for recognizing the cellophane fallacy in coordinated effects cases, but not in unilateral effects cases. In both situations, mergers may involve "entrenchment" of pre-merger market power.

    - A dominant firm with unilateral market power may entrench its market power by acquiring a potential entrant or fringe competitor that might expand and challenge a monopolist in the future.[9]

[9] For example, there may be situations where a dominant firm subtracts the supply provided by fringe competitors at different prices from the market demand curve and then sets a monopolistic price based on its costs and the "residual demand curve." In such a situation, elimination of a fringe competitor that is particularly well-positioned to expand in the future may entrench the dominant firm's market power. For a review of several models that capture dominant firm behavior, including a Forchheimer model that involves a residual demand curve, see F.M. Scherer and David Ross, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE (1990) at 221-226. This type of model is also discussed briefly in the *Commentary*. (*Commentary* at 25)

        - Similarly, a group that has successfully coordinated their pricing so that pre-merger prices are above competitive levels may entrench their ability to sustain these monopolistic prices by eliminating potentially disruptive competitors (sometimes called "mavericks") or by changing the market structure in some other way that makes it easier to sustain the prices.

    - Given this, the *Guidelines* should be revised to recognize that a price below the prevailing price *may be used* by the Agency when there is evidence of the exploitation of market power by incumbent firms, even if the pre-merger monopolistic pricing results from unilateral market power.

    - In addition, the *Guidelines'* discussion of this issue should be expanded to indicate more clearly when the Agencies are likely to use prices below current levels because current prices are already at monopolistic levels.

        - The Agencies should point out that they are likely to use current prices when evaluating elasticities if they are exploring the possibility that the merger will lead to even higher prices.

            - For example, if a dominant firm's pricing (while above competitive levels) is constrained by a potential substitute supplied by its merger partner, the merger may allow the dominant firm to charge even higher post-merger prices because the merger gives it control over the pricing of a close, if not the closest, substitute. In this type of situation, an analysis of substitution at current prices is appropriate because focusing only on substitution at lower competitive prices might miss some of the potential anticompetitive effects of the merger.

            - Similarly, when the concern is that a merger will lead to higher prices because it will allow a collusive group to coordinate more effectively, the relevant elasticities are best measured at current prices.

        - The Agencies should also point out that, when possible "horizontal entrenchment" of a dominant firm or coordinating group is the focus of the investigation and there is evidence that prices are already above competitive levels, the Agencies will employ estimates of competitive prices when there is a concern that the investigating Agency would understate the pre-merger market power of the merging firms because of the cellophane fallacy.

- ***The Guidelines should provide an economically-based definition of a "submarket" and how "submarkets" will be analyzed (if at all) by the Agencies.***

    - The Supreme Court has recognized that, within a broad market, "well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes." *Brown Shoe Co. v. United States*, 370 U.S. 294, 325, 8 L. Ed. 2d 510, 82 S. Ct. 1502 (1962); see also *Rothery Storage & Van Co. v. Atlas Van Lines, Inc*., 253 U.S. App. D.C. 142, 792 F.2d 210, 218 (D.C. Cir. 1986)(Bork, J.), cert. denied, 479 U.S. 1033, 93 L. Ed. 2d 834, 107 S. Ct. 880 (1987). In discussing submarkets, the Court explained that "because Section 7 of the Clayton Act prohibits any merger which may substantially lessen competition 'in any line of commerce,' it is necessary to examine the effects of a merger in each such economically significant submarket to determine if there is a reasonable probability that the merger will substantially lessen competition. If such a probability is found to exist, the merger is proscribed." *Id.*

    - While the FTC has used the concept of "submarkets" over the years (see e.g., *Federal Trade Commission v. Staples, Inc*., 970 F. Supp. 1066 (D.D.C. 1997)), it is my impression that DOJ has been more reluctant to employ the concept of "submarkets." While both Agencies presumably focus on the "smallest group of products that satisfies [the SSNIP] test" (§1.11),[10] it is unclear whether the use of the term "submarket" by the FTC and courts implies something other than the smallest, well-defined relevant market. Moreover, the Agencies' *Commentary on the Merger Guidelines* (2006) does not mention submarkets, although there is some discussion of the application of the "smallest market principle."[11] Given that courts recognize the concept of "submarkets," that there may be some divergence between the FTC and DOJ with respect to the use of this concept, and that the current *Guidelines* do not provide an explanation of how the "smallest" market concept relates to the concept of "submarkets," there is reason for revised *Guidelines* to address this topic.

    - Given this, the revised *Guidelines* should indicate that the Agencies use the term "submarket" to refer to the smallest, well-defined relevant product market that satisfies the SSNIP test that is relevant to the

10 The *Guidelines* refer to this as the "'smallest market' principle." (Guidelines, §1.21)
11 *Commentary* at 6-8.

analysis of a particular merger. If the Agencies sometimes consider several related markets when analyzing a particular merger, including either several submarkets or a submarket and a larger market in which the submarket is nested, the *Guidelines* should be expanded to explain when, why, and how this is done. If the Agencies do not do this, this should be explained too.

- The *Guidelines* might also elaborate more on the circumstances in which a broader relevant market might be used, even though the overlap between the merging firms involves a product that is in a well-defined submarket. While the *Guidelines* and *Commentary* recognize that some aggregation may be done in a particular case for the sake of "convenience,"[12] there is no explanation of other circumstances where the Agencies might employ a broader market.

- In addition, the Agencies should explain that the relevant markets that they use in analyzing mergers are specific to particular mergers because they start by looking at competitive overlaps between the two merging firms.[13] For example, while a hypothetical monopolist that supplies product A may be able to profitably raise the price of A above the competitive level (and thus product A might be a relevant submarket), a merger that involves a supplier of product A and another firm that supplies product B will start with a broader market that includes both products A and B. As a result, the "relevant market" for a merger of two suppliers of product A, may be a "product A" submarket and the relevant market for a merger between a product A supplier and a product B supplier will be broader, assuming the supply of product B places some competitive constraint on the pricing of product A, which might be the case if the price of A has already been elevated above the competitive level.

[12] See *Guidelines* §1.321, n. 14 that describes the practice of aggregating smaller markets "as a matter of convenience." See also *Commentary* at 8-9 (where the Agencies have commented that they "may act conservatively and focus on a market definition that might not be the smallest possible relevant market. For example, the Agencies might focus initially on a bright line identifying a group of products or areas within which it is clear that a hypothetical monopolist would raise price significantly and seek to determine whether anticompetitive effects are—or are not—likely to result from the transaction in such a candidate market. If the answer for the broader market is likely to be the same as for any plausible smaller relevant market, there is no need to pinpoint the smallest market as the precise line drawn does not affect the determination of whether a merger is anticompetitive. Also, when the analysis is identical across products or geographic areas that could each be defined as separate relevant markets using the smallest market principle, the Agencies may elect to employ a broader market definition that encompasses many products or geographic areas to avoid redundancy in presentation.")

[13] One reason for clarifying this is that courts or others may be tempted to rely on conclusions about relevant markets that were made in one case to define the relevant market in another case that involves firms with somewhat different competitive overlaps.

- ***The Guidelines should clarify the circumstances under which a relevant market may be defined as a portion of a continuous chain of substitutes even when no readily apparent gap exists.***

    - The *Commentary* points out that the Agencies may define a relevant market that contains only a portion of a chain of substitutes for which there is no obvious break in the chain.[14] However, the *Commentary* does not provide examples of where this has been done or outline the procedures used to identify the portion of the chain that is included in the relevant market. Similarly, while the SSNIP approach outlined in the *Guidelines* is consistent with the "chain of substitutes" analysis mentioned in the *Commentary* and (as is explained below) one can apply the traditional SSNIP test fairly directly to this situation, the *Guidelines* do not address the application of the SSNIP approach to a "chain of substitutes" situation explicitly.[15] The *Guidelines* should clarify whether the Agencies will settle on a single chain segment, if it is a well-defined market, or consider several different segments of the chain, which all meet the SSNIP test. If it is the former, they should explain how this single chain is selected.

    - My sense is that it is not uncommon for the Agencies to encounter markets where there are "chains of substitutes."[16] Assuming that this is the case, it would be helpful for the Agencies to describe the procedures they use to identify markets within these chains of substitutes and to report any studies that have been done that confirm that these procedures lead to appropriately defined markets (including any studies of consummated mergers). If no studies have been done, the Agencies should sponsor such studies.

    - One would infer from the *Guidelines* that the Agencies would be likely to employ a methodology that is based on both the SSNIP and

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[14] The *Commentary* observes that "[e]ven when no readily apparent gap exists [because cases involve products "for which substitutes exist along a continuum"] drawing a market boundary within the chain may be entirely appropriate when a hypothetical monopolist over just a segment of the chain of substitutes would raise prices significantly." (*Commentary* at 15.)

[15] The *Guidelines* do mention that when there is "a wide gap in the chain of demand substitutes at the edge of the product or geographic market," the Agency is likely to conclude that "more market power is at stake in the relevant market than in a market in which a hypothetical monopolist would raise price by exactly five percent." (*Guidelines*, §1.522) This discussion implies that standard SSNIP analysis is used to determine whether a segment of the chain of substitutes is a relevant market, but is not as explicit as it should be.

[16] Some of the mergers used as examples in the *Commentary* appear to involve products that are in a "chain of substitutes." For example, consider the Nestle-Dreyer merger (FTC 2003), where there may have been "premium ice creams" that link "super premium ice creams" to "standard" ice creams. (*Commentary* at 6.) Similarly, while it relates to geographic market definition (rather than product market definition), the Agencies are likely to encounter this problem in hospital mergers (perhaps in Tenet-Slidell (FTC 2003), *Commentary* at 7.)

"smallest" market concepts outlined in the *Guidelines*. In particular, an Agency is likely to start the analysis with the smallest segment of the chain (or the smallest cluster of products, if the cluster is multi-dimensional, rather than being linear) that contains products sold by both of the merging parties. It would then undertake a standard SSNIP assessment of whether a hypothetical monopolist that controlled all the products in this segment of the chain could profitably raise prices above the competitive level. If the Agency determines that such a hypothetical price increase would be profitable, then the Agency has a well-defined product market. If not, the Agency would have to lengthen the chain and repeat the process (as is described in the *Guidelines*' general discussion of market definition). If this is what is done, it would be good to clarify that this analysis is applied to matters that involve a "chain of substitutes."

- While it appears to be fairly straightforward to develop a SSNIP-based approach to testing a chain of substitutes for segments that are well-defined markets, it is more difficult to identify empirical tests that will allow one to measure diversion rates across different links in the chain and that will also consider "other factors" that may affect the profitability of increasing prices over a segment of a chain of substitutes.[17] Moreover, the *Guidelines* and *Commentary* do not provide clear guidance as to exactly what "other factors" are considered or how they are factored into the analysis.

    - Is the reference to "other factors" an allusion to supply-side issues, such as product repositioning and entry? If so, the Agencies need to consider how the supply-side of the market is interacting with the demand side to define a relevant product market, since the current *Guidelines* focus on the demand-side of the market to define the market and the supply-side issues relate to identifying which firms are in the relevant market.

    - Does the reference to "other factors" include sophisticated pricing strategies that involve raising prices for only some links of the chain and not others? If so, the Agencies should describe the types of market characteristics and time frames they consider when determining if these more sophisticated pricing strategies are realistic in a particular market context.[18]

[17] As the *Commentary* points out, "Although [the] lost sales may be insufficient to deter a hypothetical monopolist from raising price significantly, combined with *other factors*, they may be sufficient to make anticompetitive effects an unlikely result of the merger." (*Commentary* at 15) (emphasis added)

[18] With respect to market characteristics, the feasibility of price discrimination over segments of the chain is clearly important and there is already some discussion of how the Agencies evaluate the feasibility

- Does the reference to "other factors" include the determination of the profit margins that are used in the assessment of the profitability of a SSNIP? If so, the Agencies should describe how the Agencies will identify the appropriate profit margins to use in this analysis.

Question #6: Geographic Market Definition

- ***The Guidelines approach to geographic market definition should be clarified so that it is clear that a relevant geographic market is designed to include the suppliers that can serve the locations of particular customers.***

    - As the *Guidelines* already indicate, the focus of merger review is on whether a merger will likely create or enhance the ability of a firm to charge monopolistic prices.[19] Given this, the focus is on the target of potential monopolization, which is best described as customers in a particular area.[20]

    - Suppliers that are located near each other may or may not be able to cost-effectively supply the same areas (or increase supplies to areas that they already supply). The reason for this is that even manufacturers that are located relatively near each other may face very different structural constraints, such as production costs, transportation costs, access to distribution, product characteristics, and contractual responsibilities.

        - Firms can have different manufacturing costs. This means that the costs of supplying product to a particular location may

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of price discrimination in the *Guidelines* and *Commentary*. (See e.g., *Guidelines* at §1.12 and §1.22 and *Commentary* at 7) However, other structural characteristics may be relevant in some cases, and thus should be considered. For example, for a manufacturer of a consumer product one might ask: Will the hypothesized shift in pricing strategy have adverse implications for product reputation or the support the product gets from retailers (such as product positioning on store shelves and/or retailer mark-ups)?

With respect to time frames, the *Guidelines* should make it clear that the pricing theories that are used to define the relevant market are also the basis for any entry analysis that is done. This is important because it may be that the pricing strategy (including price discrimination) that supports the conclusion that a particular segment of the "chain of substitutes" is a well-defined market may also makes entry likely, undermining the profitability of the potentially anticompetitive pricing strategy that was assumed when defining the narrower relevant market.

[19] See e.g., *Commentary* at 1 ("the Agencies focus their horizontal merger analysis on whether the transactions under review are likely to create or enhance market power" [defined as "the ability profitably to maintain prices above competitive levels for a significant period of time"]).

[20] For a detailed discussion of geographic market definition in an international context which describes the factors that define the relevant market in terms of who can supply U.S. customers, see e.g., George Hay, John C. Hilke, and Philip B. Nelson, *Geographic Market Definition in an International Context*, 64 CHICAGO-KENT LAW REVIEW 711, (1988) (focusing on the "range of possible suppliers for many goods and services to U.S. consumers"). [Hereinafter, *Hay, Hilke, Nelson*]

differ, which can affect the profitability of serving a particular area.

  - Firms that are near each other may still have very different transportation costs (e.g., one may have direct water access and the other may have to truck the product).

  - Firms may employ different distribution networks, which may affect their ability to cost-effectively serve customers in a particular location.

  - Manufacturers' products may be differentiated in ways that make them more or less attractive in particular regional markets, which will affect their ability to compete effectively in different areas.

  - Firms may have committed their capacity to particular customers in particular locations which may limit their ability to sell in other areas.

- The terse discussion in the *Guidelines* increases the risk that courts or others may inappropriately use short cuts to define the relevant market, which may lead to overly broad or narrow markets. The *Guidelines* should make it clear that it is important to undertake a detailed empirical analysis of the structural characteristics of markets that shape trade flows.

- ***The Guidelines should recognize more explicitly that foreign production is often a very real competitive force that disciplines U.S. prices.***

  - While some economists have argued that one can identify the firms that can serve a particular location by looking at historical trade flows,[21] it has come to be recognized that the review of trade flows is just the starting point of the analysis. Only by undertaking a detailed analysis of relevant structural characteristics of the market, can one sort out the ability of particular suppliers to discipline price increases.

    - A journal article I coauthored provides a detailed theoretical and empirical analysis of this point.[22]

[21] See e.g., Kenneth G. Elzinga & Thomas F. Hogarty, *The Problem of Geographic Market Definition in Antimerger Suits*, 18 ANTITRUST BULLETIN 45 (1973) and William M. Landes & Richard Posner, *Market Power in Antitrust Cases*, 94 HARVARD LAW REVIEW 937 (1981).

[22] See Hay, Hilke, Nelson.

- In particular, it identifies a variety of structural characteristics that should be considered when defining geographic markets.[23]

- While the current *Guidelines* and *Commentary* provide some guidance that should minimize mistakes associated with simplistic efforts that focus on historical trade patterns, the current discussion in the *Guidelines* and *Commentary* is somewhat terse and should be expanded.[24] It would be helpful to elaborate on the treatment of legal and regulatory barriers. In addition, it would be helpful if the discussion were expanded to provide more details on what structural characteristics the Agencies consider and how the Agencies analyze these structural characteristics.[25]

- While the current *Guidelines* and *Commentary* recognize that actual and potential imports may discipline pricing in the U.S., the ability of foreign producers to serve the U.S. market with quality products has been growing over time. As a result, there are likely to be some markets where foreign competition is a viable option today where this was not the case in the past. Moreover, there can also be markets where foreign competitors are on the cusp of serving the U.S. and a post-merger price increase would lead to their full-fledged entry into the U.S. Given this, it is important that the Agencies continually update their understanding of the ability of foreign firms to serve the U.S., recognizing both that the absence of significant imports does not necessarily signal that foreign producers cannot discipline U.S. pricing

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23 While the article focuses on market definition when there are imports (or the threat of imports), much of the analysis would carry over to the analysis of regional markets within the U.S.

24 The *Guidelines* discussion focuses on four types of evidence: "(1) evidence that buyers have shifted or have considered shifting purchases between different geographic locations in response to relative changes in price or other competitive variables; (2) evidence that sellers base business decisions on the prospect of buyer substitution between geographic locations in response to relative changes in price or other competitive variables; (3) the influence of downstream competition faced by buyers in their output markets; and (4) the timing and costs of switching suppliers." (*Guidelines*, §1.21) This discussion does not get into any detail about the structural characteristics of the geographic markets that are likely to determine whether buyers will shift purchases and whether sellers will have to base business decisions on the threat that buyers will turn to suppliers in other areas, only indicating that the Agencies consider the "timing and costs of switching suppliers" and the feasibility of geographic price discrimination. (*Guidelines*, §1.21 and §1.22) At a later point, the *Guidelines* also point out that "In measuring a firm's market share, the Agency will not include its sales or capacity to the extent that the firm's capacity is committed or so profitably employed outside the relevant market that it would not be available to respond to an increase in price in the market." (*Guidelines*, §1.41)
The *Commentary* does not have a separate section that discusses geographic markets; instead it provides an integrated discussion of product market and geographic market definition that is designed to give the reader a feel for the general analytical approach the Agencies employ. (*Commentary* at 5-16) As a result, the *Commentary* does not provide sufficiently detailed insights into the structural characteristics that the Agencies consider when defining geographic markets or how these structural characteristics are interpreted.

25 See *Hay, Hilke, Nelson* for a detailed discussion of the types of structural characteristics that the Agencies should consider.

and that the presence of imports does not necessarily imply that foreign firms are well-positioned to discipline U.S. pricing by increasing their U.S. sales.

Questions #7, #8 and #9: Measurement and Interpretation of Market Shares

- ***The Agencies should provide additional commentary describing the factors that they consider when determining how to measure market shares.***
  - The *Guidelines* describe how market shares are calculated, while the *Commentary* does not.
    - The *Guidelines* indicate that market shares for all firms (or plants) identified as market participants will be measured based on sales or capacity currently devoted to the relevant market together with that which likely would be devoted to the relevant market in response to a SSNIP. The Guidelines also indicate that sales may be measured in dollar terms or physical terms (using sales, shipments, production, capacity, or reserves). (§1.41)
    - The *Guidelines* also provide the general guidance that "the best indicator of firms' future competitive significance" will be used (§1.41) and describe some of the considerations that affect what measure is viewed as "the best." (§1.41)
    - The Commentary does not provide details on how market shares are calculated, largely focusing on the points that market shares and concentration levels are just a starting point for the analysis and describing a merger (Boeing-McDonnell Douglas) where historical shares were not felt to be indicative of the ability to compete in the future.[26] (*Commentary* at 15-16)
  - While a more detailed discussion of how market shares are calculated probably should be provided, it may make more sense to provide this technical detail in additional commentary, rather than directly in the *Guidelines* (except perhaps by a cross-reference to guidance that is provided elsewhere).
    - An obvious starting point for an expanded commentary on the calculation of market shares and concentration statistics would

[26] The *Commentary* also has discussions of other circumstances where the Agencies determined that a firm's competitive position was eroding so that historical market shares overstated the competitive significance. See e.g., discussion of R.J. Reynolds-British American (FTC 2004). *Commentary* at 19.

be a review of the existing economics literature. I helped prepare a review of this literature for the American Bar Association that was published by the ABA in 2005 that might serve as a starting point.[27]

- In the expanded commentary, the Agencies should address the following types of topics:

  - How do the Agencies treat captive production of an input that is used by a vertically integrated firm when analyzing competition between suppliers of the input?

  - How do the Agencies treat recycled or refurbished goods that are sold in competition with "new products" (e.g., does the pricing of used corporate jets discipline the pricing on new corporate jets)?

  - How do the Agencies determine if "all firms have, on a forward-looking basis, an equal likelihood of securing sales," (§1.41, n. 15) since this appears to be the basis for assigning firms equal market shares? Are there other circumstances in which the Agencies believe it is appropriate to use a "bidding model" that assigns firms a market share equal to 1/N, where N is the number of firms in the relevant market? When there is bidding, but the contracts are differentiated in ways that mean that only certain industry participants are well-positioned to bid, do the Agencies calculate "N" by excluding competitors that are not likely to be viewed as serious bidders? Also, if firms are not homogeneous, do the agencies ever apply a modified 1/N model that adjusts shares to reflect differences in firm capabilities?

  - Are there circumstances where products are differentiated where an Agency would consider sales based on units, rather than revenues?[28] In particular, the Agencies should provide a more detailed explanation of why they are likely to weight the sale of a jar of private label pasta sauce less than a comparable jar of branded pasta sauce when calculating market

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27 For a more detailed discussion of how market shares are measured and interpreted, see ABA Antitrust Section, MARKET POWER HANDBOOK: COMPETITION LAW AND ECONOMIC FOUNDATIONS, 71-101(2005).

28 The *Guidelines* state: "Dollar sales or shipments generally will be used if firms are distinguished primarily by differentiation of their products." (*Guidelines*, §1.41)

shares, assuming that this is the approach taken for most differentiated consumer goods.

- How do the Agencies treat a firm's capacity that is controlled by another party through long-term contracts which give the second firm the right to use and/or sell this capacity and/or the output produced by this capacity? For example, do the Agencies undertake different structural analyses of the relevant markets for different time periods, recognizing that the combination of concentration levels and "ease of entry" may differ for the different time periods (e.g., little control over capacity in short-run due to long-term contracts and easier entry in long-run, since capacity may be added before contracts expire)?

- ***While both the Guidelines and Commentary provide some description of how market shares are interpreted, this discussion should be expanded.***[29]

    - The Agencies should provide a more detailed list of the factors that might cause them to conclude that current market shares "either understate or overstate the likely future competitive significance of a firm or firms in the market or the impact of a merger." (*Guidelines,* §1.52)

    - While there is some discussion of "changing market conditions" and the "degree of difference between the products and locations in the market and substitutes outside of the market" (*Guidelines*, §1.521 and §1.522), there is much that is unsaid. Points that might be clarified in the *Guidelines* include:

        - Clarify how changes in the relative costs of competitors may affect the interpretation of market shares

        - Clarify how the diffusion of information about the quality of a competitor's product may either increase or decrease its competitive significance.

[29] See *Guidelines*, §1.52 and *Commentary* at 15-16.

- ***The Guidelines should clarify how the market share and/or concentration thresholds that define "safeharbors"[30] differ for coordinated effects and unilateral effects cases.***

    - The section of the *Guidelines* that focuses on "concentration and market shares" (*Guidelines*, §1.5) does not link the "safeharbor" analysis of concentration and shares to coordinated effects or unilateral effects theories. The reason for this appears to be that, at least at one time, §1.5 defined "safeharbors" for both types of theories.[31] However, there is some uncertainty as to whether this guidance is still accurate.

        - Since the HHI thresholds contained in the *Guidelines* were introduced in earlier versions of the *Merger Guidelines* that focused exclusively on coordinated effects, it is likely that §1.5 was designed largely with coordinated effects theories in mind.

        - The most relevant discussion of "safeharbors" for unilateral effects cases is found in the discussion of the "closeness of the products of the merging firms" where the *Guidelines* point out:

            > The market concentration measures articulated in Section 1 may help assess the extent of the likely competitive effect from unilateral price elevation by the merged firm notwithstanding the fact that the affected products are differentiated. The market concentration measures provide a measure of this effect if each product's market share reflects not only its relative appeal as a first choice to consumers of the merging firms products but also its relative appeal as a second choice, and hence as a competitive constraint on the first choice. Where this circumstance holds, market concentration data fall outside the safeharbor regions of Section 1.5, and the merging firms have a combined market share of at least thirty-five percent, the Agency will presume that a significant share of sales in the

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[30] The *Guidelines* use the term "safeharbors," rather than "safe harbors," even though it is conventional to use the two word expression (which is what is done in the *Commentary*).

[31] While §2.211 clearly makes this link for unilateral effects cases, there is no similar link to §1.5 in the section describing the "lessening of competition through coordinated interaction." (*Guidelines*, §2.1) However, the discussion in §1.5 makes it clear that this section would apply to coordinated effects cases (e.g., by cross referencing later sections that discuss coordinated effects. (*Guidelines*, §1.51)). The *Commentary* confirms that "the *Guidelines* does not establish a special safe harbor applicable to the Agencies' consideration of possible unilateral effects." (*Commentary* at 26)

market are accounted for by consumers who regard the products of the merging firms as their first and second choices. (*Guidelines*, §2.211)

- However, at one point the *Commentary* appears to move away from the *Guidelines* effort to link the "safeharbors" in §1.5 and unilateral effects theories when it comments: "Indeed, market concentration may be unimportant under a unilateral effects theory of competitive harm. . . . [T]he question in a unilateral effects analysis is whether the merged firm likely would exercise market power absent any coordinated response from rival market incumbents. The concentration of the remainder of the market often has little impact on the answer to that question." (*Commentary* at 16) In addition, while not embracing the 35% share threshold as a safeharbor for unilateral effects cases and indicating that challenges at share levels below this level may occur, the *Commentary* suggests that "as an empirical matter" the Agencies are unlikely to challenge a merger on the basis of a unilateral effects theory if the combined shares of the merging firms is below 35%.[32]

o Given the remarks made in the *Commentary* and my experience that the Agencies do not focus much on the §1.5 safeharbor thresholds when analyzing unilateral effects cases, the Agencies need to clarify the extent to which the safeharbors identified in §1.5 apply to both coordinated effects and unilateral effects cases.

o Moreover, given the differences in the economic analysis that is applied under unilateral effects and coordinated effects theories, there is a basis for using different "safeharbors" in the two situations.

  - The safeharbors used in unilateral effects cases should probably focus on the market shares of the merging firms.

  - As a practical matter, the HHI thresholds used in the current Guidelines add little to the analysis. Consider the following example: Assume that the merger involves a merged firm with a 35% post-merger share.[33] When this is the case, the post-merger HHI will exceed 1225 (35^2=1225). Moreover, if there

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[32] "As an empirical matter, the unilateral effects challenges made by the Agencies nearly always have involved combined shares greater than 35%. Nevertheless, the Agencies may challenge mergers when the combined share falls below 35% if the analysis of the mergers' particular unilateral effects indicates that they would be likely substantially to less competition." (*Commentary* at 26.)

[33] As is pointed out above, the *Guidelines'* treatment of unilateral effects cases typically arise when the merging firms have a combined market share of at least thirty-five percent. (*Guidelines*, §2.211)

are at least two firms with market shares of 20% or higher (which is likely), the HHI will exceed 1800 ($35^2 + 20^2+20^2=2025$). This simple example implies that the current HHI thresholds are unlikely to influence the Agencies' analysis in unilateral effects cases. If a measure of the competitive significance of the other firms in the market is desired, it would appear to make sense to tailor this measure to the unilateral effects theory, rather than trying to use the same thresholds that are thought to apply to coordinated effects cases.

- In contrast, coordinated effects cases could continue using the current thresholds for HHIs and change in HHIs (or thresholds that are adjusted somewhat to reflect more recent Agency activities and learning).[34]

- ***The Agencies should expand the commentary they provide on the "factors affecting the significance of market shares and concentration," especially the discussion of how market shares are measured and interpreted in dynamic markets.***

    - The *Guidelines* only provide a few "examples" of the situations where market share and market concentration levels may understate or overstate the likely competitive significance of a merger. (*Guidelines*, §1.52) While these examples are helpful, it would be good to elaborate by providing other examples.

    - The *Guidelines* and *Commentary* make it clear that the Agencies consider changes in market conditions that may affect the future competitive significance of firms. While it appears that clear evidence that a firm is failing or that it will not compete for future contracts is considered and can be determinative,[35] the Agencies have not provided sufficiently detailed insights into how they evaluate firms that are "flailing," but not exiting. Similarly, there is little discussion of how

[34] I recognize that employing two separate standards for defining "safeharbors" may appear to complicate the analysis for the merging parties that are trying to anticipate how the Agencies will react to a merger. However, this approach appears to line up better with the economics, more closely reflect what the Agencies appear to be doing, and will not add too much of a burden since it should be possible to develop thresholds that are based on the same share data that are used to calculate the HHIs that are used under the current *Guidelines*.

[35] The *Guidelines* indicate that "if a new technology that is important to long-term viability is available to other firms in the market, but is not available to a particular firm, the Agency may conclude that the historical market share of that firm overstates its future competitive significance." (*Guidelines*, §1.521) The *Commentary* describes the Boeing-McDonnell Douglas merger as an example where the FTC concluded (based on statements by purchasers of aircraft and presumably other sources of information) that McDonnell Douglas' prospects for future aircraft sales were close to zero and that it was unlikely that this situation could be reversed. (*Commentary* at 16)

the Agencies adjust market shares upward in situations where a firm's market share is growing as the result of a competitive advantage that is expected to be sustained in the future.

- Presumably, the Agencies look at the internal share projections of the merging firms. If this is the case, the Agencies should probably indicate that this is important evidence.

- However, it is unlikely that the Agencies will want to take internal share estimates as gospel (even if they are a good starting point). It would appear to be appropriate for the Agencies to undertake some due diligence of these internal share projections. However, there is no discussion of what due diligence might be done by the Agencies or the circumstances under which the Agencies will substitute their own share projections for the projections contained in the ordinary course of business documents.

    - The Agencies should make it clear that they use available data on supply/demand factors and historical shares to undertake projections to test the realism of any projections obtained from other sources.

    - The Agencies should also make it clear that these statistical efforts are supported by more detailed studies of the underlying structural characteristics of the firms and markets to identify the source of any changes that are observed.

- There is only limited discussion of the structural characteristics of firms and markets that the Agencies consider when determining whether recent changes in market shares (and concentration levels) signal a trend towards a new equilibrium or some more transitory phenomena.[36] While it is recognized that changes in technology may be important, there are numerous other factors that should be considered. Examples include:

    - Changes in tariffs or other trade barriers that limit the ability of foreign competitors to serve the U.S. cost-effectively.

[36] The Agencies indicate that they "will consider reasonably predictable effects of recent or ongoing changes in market conditions interpreting market share concentration and market share data." (*Guidelines*, §1.521) However, there is little elaboration on this point in the *Guidelines*.

        - Changes in state or federal regulations that change market structure (e.g., changes in environmental regulations might change the product attributes that are important to customers).

        - Changes in the information that provides customers with new insights into the quality of products (perhaps through recent product trials or laboratory tests).

        - Changes in relative input costs that benefit competitors with one type of technology over rivals that have adopted an alternative technology.

        - Changes in capacity levels that will affect the ability of firms to compete in the future (e.g., either allowing rivals that were capacity constrained to increase their future output or preventing rivals from selling as much as they have in the past because capacity was eliminated).

        - Changes in customer tastes.

        - Changes in contractual relationships that will alter the control over the output from major facilities.

    - While it may not be appropriate to add all of this material to the *Guidelines*, it would be helpful to elaborate on these points through complementary commentary that might be referenced in the *Guidelines*.