**COMMENTS TO THE FEDERAL TRADE COMMISSION AND DEPARTMENT OF JUSTICE ANTITRUST DIVISION**

**HMG REVIEW PROJECT - COMMENT, PROJECT NO. P092900**

# Unified Merger Analysis: Integrating Anticompetitive Effects and Efficiencies, and Emphasizing First Principles

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We submit these comments in response to the Federal Trade Commission and Antitrust Division's request for comments on the Horizontal Merger Review Guidelines Project.

At the outset, we must stress that we do *not* advocate substantial revision of the existing Merger Guidelines. As a general matter, we find that the 1992 Guidelines (with their 1997 revisions) have well served the purposes of disciplining the process of horizontal merger review and notifying the public of the agencies' approach.

To be sure, the Guidelines are imperfect in several ways. Were we to write on a blank slate, we would draft some portions of the Guidelines differently. Further, as various studies (collected in the Foreword of the 2006 Commentary on the Horizontal Merger Guidelines) have revealed, agency practice has differed at times from what a strict reading of the Guidelines might have predicted. To the extent that the Guidelines are meant to achieve transparency, periodic revision of the Guidelines to conform not merely to the agencies' aspirations but also to their historic practices might be desirable.

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Against these interests in revision, however, must be balanced the risks of tinkering with a document that has passed the tests of time and continues to maintain a broad bi-partisan consensus. The mere possibility of improving the text is an insufficient justification for beginning a process of substantial revision that will draw out many competing interests and agendas and could result in greater uncertainty, reduced transparency, and even an inferior set of Guidelines.

It is our judgment that, for now, it would be better for the most part to leave the text of the Guidelines alone. Whatever gains the revisions might achieve in terms of methodological improvements and transparency are likely to be more than offset by the risks of overly complicating merger analysis, decreasing transparency, or even creating an inferior set of standards. In short, our view is that, with one exception, it would be best to let sleeping dogs lie.

The one area where clarification can have an impact with little downside risk relates to the concentration thresholds. The data produced by the Federal Trade Commission and the Antitrust Division make clear that the HHI thresholds in the Guidelines have been obsolete for twenty years and do not reflect the agencies' practice. We recommend that the concentration thresholds be brought up to date.

Nonetheless, in the event that the Guidelines are to undergo substantial revision, we offer a few words on one of the topics on which the agencies requested comments—efficiencies. Our comments here are somewhat abstract. For example, we do not attempt to offer concrete guidance on estimating the impact on price of different sorts of efficiencies (i.e., marginal cost reductions, R&D expenditures). Rather, we suggest a unified approach on how to weight efficiencies and anticompetitive effects based on what we understand the current purpose of the Guidelines to be – the prevention of transactions that increase market power and reduce consumer welfare. We believe that as a theoretical matter the way to be true to this purpose is to perform an analysis of efficiencies and anticompetitive effects that accounts for the probability that either type of effect will be realized, as well as the time value of money. Accordingly, we propose a risk adjusted net present value (NPV) approach.

Our view is that the current tone of the Guidelines unjustifiably discriminates between anticompetitive effects and efficiencies by implicitly giving greater weight to equally probable (and time-value adjusted) anticompetitive effects than comparable efficiencies. We believe that the reasons for this bias are historical and outdated and that contemporary merger policy should treat equally probable anticompetitive effects and efficiencies equally.

In order to understand the bias currently exhibited in the Guidelines, it may be helpful to look back to the 1982 Guidelines. One of the great contributions of the 1982 Department of Justice Merger Guidelines[3] was their recognition of the importance of first principles. The 1982 Guidelines, as they relate to horizontal mergers, organized themselves around the unifying theme of prohibiting transactions that significantly create or enhance the exercise of market power, either by creation of a dominant firm or by enabling multiple firms to engage in tacit or overt

[3] 1982 Department of Justice Merger Guidelines, reprinted at 4 Trade Reg. Rep. (CCH) ¶ 13.102 (1982 Merger Guidelines).

collusion. The explanation accompanying issuance of the guidelines stated specifically that the goal of the Guidelines market definition paradigm is to "identify and consider all firms that would have to cooperate in order to raise price above competitive levels and keep them there."[4] Thus, the market definition exercise was geared precisely to the ultimate goal of the Guidelines. The section dealing with Ease of Entry was similarly focused, looking to whether "entry into the market is so easy that existing competitors could not succeed in raising price for any significant period of time…"[5]

Efficiencies have historically been among the must frustrating issues for antitrust counsel to deal with. At the outset of modern antitrust merger law, efficiencies were considered a reason to prohibit a merger, not to allow it.[6] Slowly over time, this situation was reversed as economic analysis increased its significance in antitrust jurisprudence. Still, merger efficiencies bear some baggage from an earlier period where they were viewed with suspicion.

To this day, the agencies focus the overwhelming majority of their efforts in merger analysis on market definition and competitive effects, and to the extent they talk about efficiencies, it tends to be in a derogatory way. One comes away from experiences with the agencies and the courts with the feeling that efficiencies have a stigma attached to them that is very difficult to erase. Although the rhetoric has improved, the reality has not. As former Chairman Muris has observed, "[t]oo often, the Agencies found no cognizable efficiencies when anticompetitive effects were determined to be likely and seemed to recognize efficiency only when no adverse effects were predicted."[7] Essentially, efficiencies have been used as a justification for not finding anticompetitive effect. The only real significance of efficiencies today seems to be as evidence that something other than market power motivated the transaction, which then makes the agencies more comfortable concluding that no anticompetitive effects are likely.

A tighter focus on the first principles of merger analysis with respect to efficiencies as well as competitive effects may improve this situation. The ultimate exercise is to make a prediction about the overall effects of a merger over the reasonably foreseeable future. Admittedly, this is difficult to do in practice, but if we know what direction we are supposed to be moving, we have a better chance of getting to where we want to be. And even if we cannot get very close given the tools at hand today, better tools will likely be developed over time if there is a perceived need. This has been the experience with market definition and competitive effects analysis under the Guidelines.[8]

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[4] Department of Justice Press Release, reprinted at 4 Trade Reg. Rep. (CCH) ¶ 13.102.

[5] 1982 Merger Guidelines at § III.B.

[6] *See* Brown Shoe Co. v. United States, 370 U.S. 294, 344 (1962).

[7] T. Muris, "The Government and Merger Efficiencies: Still Hostile After All These Years," 7 GEO. MASON L. REV. 729, 731 (1999).

[8] D. Scheffman, M. Coate, and L. Silvia, "Twenty Years of Merger Guidelines Enforcement at the FTC: An Economic Perspective," 71 ANTITRUST LAW JOURNAL 277 (2003) (market

From a theoretical point of view, the way to determine whether the overall effect of a merger is to reduce consumer welfare is to perform a risk-adjusted net present value calculation. In other words, we would estimate the magnitude of any price effect[9], the probability that it will be realized, its timing and duration. We would do the same for efficiencies. That is, we would estimate the magnitude of any efficiencies and their effect on price, the likelihood that they will be realized, their timing and their duration. Then we can see the expected costs and benefits to consumer over time and make a net present value calculation. Whether the merger is challenged or not should depend on whether the NPV is positive or negative for consumers.

Let us provide an illustration. Suppose we are presented with a potential merger of two widget producers and we conclude as follows:

- The market is widgets with 80% probability
- Entry will not occur for 2 years with 80% probability
- Anticompetitive effects (given the market definition and entry conclusions) are a 10% price rise for 2 years with 80% probability
- Marginal cost will decline and impact price by 2% with 70% probability beginning in year 2 and continuing through year 5
- Pecuniary costs will decline and impact price by 1% with 70% probability beginning in year 1 and continuing through year 5
- Fixed costs will decline and impact price by 1% with 70% probability beginning in year 3 through year 5

These assumptions are summarized on the following spread sheet, which performs the net present value calculation for that flow of positive and negative benefits resulting from this hypothetical transaction. It shows that even though the merger is projected to raise price by 10% for two years, the net projected effect on consumers is positive.

definition and competitive effects); G. Werden, "The 1982 Merger Guidelines and the Ascent of the Hypothetical Monopolist Paradigm," 71 ANTITRUST LAW JOURNAL 253 (2003) (market definition).

[9] The term "price" used in these remarks is meant to refer to the concept of a quality adjusted price.

**Consumer Welfare NPV Spreadsheet**

| | Prob | Harm/Bn | Risk Adj. | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|---|---|---|
| **Competitive Effects** | | | | | | | | |
| Market Definition | 0.80 | | | | | | | |
| Entry | 0.80 | | | | | | | |
| Anticompetitve Effects | 0.80 | -10 | | | | | | |
| Total | 0.51 | -10.00 | -5.1 | -5.1 | -5.1 | 0.0 | 0.0 | 0.0 |
| | | | | | | | | |
| **Efficiencies** | | | | | | | | |
| Marginal Cost | 0.7 | 2 | 1.4 | 0.0 | 1.4 | 1.4 | 1.4 | 1.4 |
| Pecuniary Benefit | 0.7 | 1 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 |
| Fixed Cost Benefit | 0.7 | 2 | 1.4 | 0.0 | 0.0 | 1.4 | 1.4 | 1.4 |
| | | | | | | | | |
| **Total Effect** | | | | -4.4 | -3.0 | 3.5 | 3.5 | 3.5 |

**NPV** @ 0.1
0.68

Of course, the agencies cannot engage in a precise mathematical calculation. We probably do not have the tools, at least not yet, to do that. On the other hand, we can do the analysis in a broad way, be cognizant of the ultimate purpose, and perhaps most importantly, be transparent about the assumptions we are making in our analysis. By being transparent in this fashion, we can expose inconsistencies and flaws, and provide incentives to develop new techniques.

Among other things, this approach helps to define what efficiencies are cognizable, how to evaluate them, and how to weight them. And just as importantly, it does the same for competitive effects. In fact, what it shows is that everything is relative. The larger, the more likely, and the longer the adverse competitive effects, the larger, the more likely and the longer must be the offsetting efficiency effects -- with the weighting determined by the NPV calculation.

For instance, the example in the spreadsheet illustrates that efficiencies occurring in years three through five can be determinative and should not be ignored or treated with the back of the hand. The spreadsheet also shows how competitive effects probabilities can be dependent on market definition and entry estimates, which can focus the mind on the confidence (or lack thereof) with which anticompetitive effects are predicted in many cases. And since everything is relative in this analysis, the level of confidence in the efficiencies necessary to avoid a reduction in consumer welfare is impacted by estimate of the probability of anticompetitive effect.

This analysis also suggests something about burdens. If the plaintiff can marshal facts that, absent efficiencies, demonstrate a harm to consumers, then the plaintiff has made out a prima facie case. If no other evidence (i.e. no efficiencies) is presented, the plaintiff should win. If the defendant can show that the merger will result in likely efficiencies that prevent the price from rising in a net present value sense, the plaintiff has demonstrated that the merger will not reduce consumer welfare. If the plaintiff produces no additional evidence, the fact finder would have no reason to go on and the inquiry should end. If, however, the defendant can refute the efficiencies and/or demonstrate that prices would have been lower absent the merger (i.e. that some or all of the efficiencies are not merger specific), then a harm to consumer welfare has been proven and the defendant should win. Proving lack of merger specificity in the context of a consumer welfare calculation means a showing that the efficiencies would have been realized and resulted in lower prices in even the absence of the transaction, and that burden should lie with the plaintiff. And given the time it would take to negotiate and execute an alternative transaction, there will usually be a significant timing difference.

Finally, creating a general but clear framework gives the antitrust community direction for further developments in merger efficiencies analysis. Several authors have made significant contributions already in this regard. With respect to static analysis, Greg Werden has developed a methodology for determining the marginal cost reductions sufficient to prevent price increases involving unilateral effects for differentiated products,[10] while Werden and Luke Froeb have

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[10] G. Werden, "A Robust Test for Consumer Welfare Enhancing Mergers among Sellers of Differentiated Products," 44 J. INDUS. ECON. 409 (1996).

develop an approach for homogeneous products.[11] Professor Hausman has an interesting article on this topic as well, suggesting that 50% should be the minimum pass-through for marginal cost reductions.[12] We expect that other commentators will suggest other mechanisms for calculating the probability and magnitude of merger efficiencies. Our goal here is not to suggest such specific mechanisms but to recommend that, should the Guidelines be revised, they reflect a general principle of symmetrical treatment for anticompetitive effects and efficiencies.

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[11] L. Froeb & G. Werden, "A Robust Test for Consumer Welfare Enhancing Mergers among Sellers of a Homogeneous Product," US Dept. of Justice Antitrust Division, Economic Analysis Group Discussion Paper 97-1 (1997).

[12] J. Hausman and G. Leonard, "Efficiencies From the Consumer Viewpoint," 7 GEO. L. REV. 707 (1999); *but see* O. Ashenfelter, "Identifying the Firm-Specific Cost Pass-Through Rate," FTC Bureau of Economics Working Paper No. 217 (1998)(estimating 21% pass through rate for Office Depot/Staples merger).