Comment on the Proposed Update on the Horizontal Merger Guidelines:

Accounting for Out-of-Market Efficiencies

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I. THE PROPOSED MERGER GUIDELINES METHODOLOGY IS LIKELY TO LEAD TO NARROWER MARKETS

There is not much debate that the methodological approach adopted by the 2010 Proposed Horizontal Merger Guidelines ("new HMGs") will result in narrower relevant markets. The Agencies believe that narrower markets are more accurate because "the competitive significance of distant substitutes is unlikely to be commensurate with their shares in a broad market."[1] The market definition analysis endorsed by the new HMGs correspondingly favors narrower markets. For example, the hypothetical monopolist test adopted by the new HMGs states that the Agencies require critical loss analysis to be consistent with data on profit margins. As others have pointed out, the value of diversion test endorsed by the new HMGs tends toward narrower relevant markets, all else held constant.[2]

♦ These comments are my own and are not submitted on behalf of any client.

[1] *Proposed Horizontal Merger Guidelines,* available at: http://www.ftc.gov/os/2010/04/100420hmg.pdf. The new HMGs also assert that excluding more distant substitutes in favor of a focus on closer substitutes "often provides a more accurate indicator of the competitive effects of the merger". *Id*.

[2] Steve Salop & Serge Moresi, *Horizontal Merger Guidelines: Summary of Proposed Revisions*, available at: http://www.crai.com/uploadedFiles/Publications/horizontal-merger-guidelines-summary-of-proposed-revisions.pdf.

Concerns have been expressed about the fact that market definitions often will be narrow, particularly in markets with substantial intellectual property.[3] The new HMGs justify these methodological changes with an appeal to ridding merger analysis of formal, lock-step presumptions in favor of more realistic competitive effects analysis that captures the competitive pressures imposed by close substitutes.

However, a much greater potential concern is that prosecutorial discretion will be the only force constraining the Agencies from successfully enjoining mergers with net consumer welfare gains despite the presence of anticompetitive effects in a narrowly defined market.

To the extent that the new HMGs approach succeeds in more accurately capturing competitive effects, these methodological changes will lead to improved merger policy from a consumer welfare perspective. But an approach that leads to narrower markets, even assuming the approach more accurately identifies anticompetitive effects, also increases significantly the potential for enforcement decisions that would enable the Agencies to successfully challenge mergers that would simultaneously violate Section 7 in one relevant market but produce net consumer welfare gains as a result of increased competition in other relevant markets. While this could increase the Agencies' win-loss record, it would not benefit consumers.

The Agencies may choose not to bring these cases under their prosecutorial discretion when the consumer benefits in the other markets arise from efficiencies that are "inextricably linked" to the merger. However, the Agencies have made no commitments. In my view, they should commit to not bringing cases that increase overall consumer welfare as a result of inextricably linked efficiencies, even if a merger reduces consumer welfare in a properly defined narrow relevant market.

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[3] See, e.g., Daniel M. Wall & Hanno Kaiser, *What the New Merger Guidelines Mean for Technology Companies* (April 24, 2010), available at: http://www.lw.com/upload/pubContent/_pdf/pub3492_1.pdf. Other commentators have expressed concern that the Agencies may not define markets at all, and thereby violate the language of Section 7. See Daniel Crane, *Whoa There Big Fellows*, Posting to Truth on the Market Blog (April 21, 2010), available at: http://www.truthonthemarket.com/2010/04/21/whoa-there-big-fellows/. In my view, the Agencies' strong incentive to avoid losing cases is a sufficient constraint to deter them from avoiding market definition altogether.

II. THE HMGs APPROACH WILL LEAD TO NARROWER MARKETS AND MORE MERGERS WITH SIGNIFICANT AND OTHERWISE COGNIZABLE "OUT OF MARKET" EFFICIENCIES

Defining narrower markets will inevitably lead to circumstances in which the consumers in the narrowly defined markets are harmed, but others are benefitted. A reasonable concern of those skeptical of the "narrow" market approach adopted by the new HMGs is that the narrower markets obscure competitive benefits of the merger that are "outside" the market. Thus, the new approach could lead to Section 7 liability for mergers that result in net increases in consumer welfare.

Consider the merger of Firms A and B who produce and sell widgets at the same price to two equally sized sets of customers, C_1 and C_2. Assume that, under the new HMGs, there is convincing evidence that the sale of widgets to C_1 is a relevant market separate from the sales of widgets to C_2 and that the post-merger firm will be able to increase the price of widgets to C_1, by 10%. Assume that, under the new HMGs, there is also convincing evidence that the sale of widgets to C_2 is a relevant market and that post-merger prices of widgets in that market will fall 20%. Thus, the merger produces net benefits for consumers taken as a whole. Suppose that the efficiency benefits that lead to the 20% price decrease in C_2 are inextricably linked to the merger including the market encompassing sales to C_1, so a divestiture in the C_1 market is not feasible.

Despite these overall consumer benefits, the merger could be successfully challenged because of its harms in market C_1. Under current merger law, the merger of A and B will violate Section 7 despite the fact that it increases consumer welfare, because *Philadelphia National Bank* precludes counting efficiencies outside the relevant market.[4] In other words, the merging parties cannot point to the consumer gains outside of the narrowly defined product market to defend the merger, even if the increase in consumer welfare is huge and dominates any potential anticompetitive effects.

Both the 1997 HMGs and new HMGs indicate that the Agencies sometimes might elect to forbear from prosecution when there are efficiencies outside the relevant market, if they are "so inextricably linked with it that a partial divestiture or other remedy could not feasibly eliminate the

[4] United States v. Philadelphia National Bank, 374 U.S. 321 (1963).

anticompetitive effect in the relevant market without sacrificing the efficiencies in the other market(s)."[5]

This "out of market" efficiency problem obviously does not originate with the new HMGs, nor with the HMGs at all. The cause of the problem is *Philadelphia National Bank*. Despite the dramatic changes in merger law since 1963, the inability to balance cross-market effects remains the law. However, the value of diversion approach to market definition is likely to dramatically increase its practical significance. The narrower markets will lead to more cases in which other groups of consumers benefit but those benefits are systematically excluded from merger analysis, even though they would otherwise meet the cognizability and verifiability requirements for efficiencies.

This failure to incorporate "out of market" efficiencies into merger analysis flies in the face of the modern trend in favor of analyzing actual competitive effects rather than adopting simplifying and potentially misleading proxies. The intellectual case in favor of excluding out of market efficiencies is not a strong one, and it becomes even weaker when the Agencies adopt an approach of ever-narrowing market definitions.

III. A PROPOSED SOLUTION: UPDATING FOOTNOTE 11 OF THE NEW HMGs TO REFLECT COMPETITIVE REALITIES

The new HMGs should be expanded to discuss how the Agencies will exercise their prosecutorial discretion in this area. The 1997 HMGs, the new HMGs, and the 2006 Merger Commentaries provide some guidance on the issue. However, the value of diversion approach adopted by the new HMGs is likely to increase the need for guidance on this score. The HMGs should make clear that they would not bring enforcement actions where the Agencies can prove anticompetitive effects in a narrower market, but where the evidence also supports the conclusion that out of market efficiencies are sufficient to eliminate consumer harm in the aggregate. This commitment would involve a simple amendment to note 11 of the new HMGs. In this way, the new HMGs can and

[5] U.S. Dep't of Justice & Fed. Trade Comm'n, *Horizontal Merger Guidelines* § 4 n. 36 (1992, rev. 1997), *available at* http://www.justice.gov/atr/public/guidelines/hmg.pdf; *Proposed Horizontal Merger Guidelines* § 10, n. 11 (April 20, 2010), *available at*: http://www.ftc.gov/os/2010/04/100420hmg.pdf; *Commentary on the Horizontal Merger Guidelines* 56-57 (March 2006), *available at*: http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf.

should go beyond “cheap talk” to “binding commitment” in order to avoid imposing needless anxiety on businesses.

The intellectual underpinnings of the new HMGs, especially with respect to market definition and diagnosing unilateral price effects, are built on the potential to shed imperfect market share proxies in favor of an approach that reflects the competitive realities of competition between close substitutes. The new HMGs should adopt the same rigorous analytical approach with respect to efficiencies. This change is further needed as a practical matter because the problem is likely to become more common in light of the narrower markets defined under the new HMGs.

To be sure, eliminating the *Philadelphia National Bank* limitation on cross-market balancing in the new HMGs would create some complexities. As a simplifying procedural rule, the limitation has some benefits. For example, relaxing the rule would result in parties more frequently making efficiencies claims outside the narrowly defined relevant market. As a result, the Agencies may need to define and analyze additional relevant markets to comprehensively assess competitive effects. Further, this approach will more frequently create the need for balancing.

While this approach may render hard cases even more difficult because of the combined complexities of defining additional markets and conducting balancing, the additional work would have value – it would permit mergers that benefit consumers. Moreover, the type of balancing needed is not new. The reality is that the Agencies already are conducting this type of analysis within a single (broader) relevant market. No merger affects every consumer identically. Whenever a merger leads to changes in brand mix by the merging firms, some consumers may be harmed while others benefit.

Nor would the proposed approach alter the burdens that already exist with respect to efficiencies under the 1997 or new HMGs. “Out of market” efficiencies should still have to satisfy the requirements of Section 10 of the new HMGs. Thus, the parties will still bear the burden of proving efficiencies.

While it is true that the additional burdens of this analysis create an additional layer of complexity, that should not get in the way of incorporating cognizable efficiencies associated with the merger. There is certainly wisdom in simplifying assumptions and rules, based on economic theory and evidence, thereby allowing generalist judges to conduct a more tractable form of antitrust analysis rather than delve into the weeds of economic theory in the name of reducing socially costly errors.[6] However, the limitation on out of market efficiencies embodied in *Philadelphia National Bank* originates from an era of antitrust where these formalistic, simplifying assumptions were neither based in economic theory nor on evidence of competitive realities. Although the proposed commitment to exercise prosecutorial discretion to protect consumer welfare would require the Agencies to ignore *Philadelphia National Bank*, the 1997 HMGs have already opened the door to considering out of market efficiencies without disastrous consequences. The proposal to amend note 11 to commit the Agencies to forbear from challenging mergers where out of market efficiencies outweigh anticompetitive effects merely updates the new HMGs in a manner consistent with the modern intellectual foundation of merger analysis.

[6] Frank H. Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1 (1984). See also Michael R. Baye and Joshua D. Wright, *Is Antitrust Too Complicated for Generalist Judges*?, 54 J. L. & Econ. (forthcoming 2011), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1319888.