Public Comments on the 2010 Draft Horizontal Merger Guidelines

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The 2010 Guidelines draft offers some major steps forward that should be complimented and embraced. It includes newly eloquent, accurate and clear articulations of some of the more difficult foundations and principles of horizontal merger analysis, while at the same time sharing and building on some of the best formulations from the '92 Guidelines. The draft forthrightly replaces the obsolete HHI thresholds with well-chosen new levels that are harmonious with current perspectives (although still not founded on empirical research into merger effects). The draft introduces an elegant logical framework for assessing competitive effects on innovation. The draft promotes a powerful new tool from the economics literature, called the value-of-diverted-sales, for analyzing unilateral competitive effects among differentiated products. And the draft explicitly clarifies what might be misconceptions of inexperienced readers of the '92 Guidelines on subjects concerning the seemingly necessary sequencing of analytic steps, including reliance on assessing concentration in delineated relevant markets.

There is much to say, consider and debate on these subjects, as well as other even deeper issues such as the proper roles of Horizontal Merger Guidelines as either a statement of policy or a collection of recipes or menus for analysis. Instead of diving into these waters, my comments here are intended to focus on a handful of narrower points where concise adjustments to the draft, in my view, would contribute important benefits. The points on which I comment below are: Mandating Relevant Markets; Is There a Safe Harbor?; How Big is a SSNIP?; Are HHIs Viewed as Useful for Analyzing Unilateral Competitive Effects in Markets for Homogeneous Goods?; How to Analyze Unilateral Competitive Effects of a Merger Involving Differentiated Products?; How Much Entry Is Enough?; and Rapid Entry Should Also Be Flexibly Reversible.

Mandating Relevant Markets

The 2010 Guidelines draft deliberately declares that delineation of a relevant market may be unnecessary for assessment of unilateral competitive effects arising from a merger involving differentiated products. In contrast, the draft does indicate that analyses of market shares are likely important to assessments of unilateral competitive effects among homogeneous products, that analyses of concentration are likely important to assessment of coordinated effects, and thus that relevant markets need to be delineated for these analyses.

In my view, the 2010 Guidelines should assert that relevant markets and corresponding market shares will be addressed and articulated wherever there are competitive effects of concern. This assertion could meaningfully be inserted into section 4, at the close of the first paragraph,

immediately after "... evaluation of competitive alternatives available to customers is always necessary at some point in the analysis."

The purpose behind a requirement of market definition and assessment of shares is the imperative for disciplined consideration of sources of competition beyond the parties' own products, along with the need to generate a consistent calibration of the strength of that additional competition. This is a practice that is probably followed much of the time at the Agencies as matter of course, and adding it to the Guidelines provides transparency and commitment that are beneficial policy.

Of course, the 2010 Guidelines should retain the clarity of the draft in explaining that market definition need not precede other analytic steps, and that evidence of competitive effects, from any reliable methodology, can inform market definition. Moreover, there is no requirement of a unique relevant market, and several alternative market definitions with their own sets of shares may be the most useful way to articulate the results of appropriate competitive analysis.

Is There a Safe Harbor?

The 2010 Guidelines draft is unclear as to whether there is a safe harbor based on lack of concentration, or a safe harbor based on any other relatively confined considerations at all. On the one hand, the language in section 5.3 of the draft Guidelines seems to indicate that there is a concentration-based safe harbor: "Mergers resulting in unconcentrated markets [HHI below 1500] are unlikely to have adverse competitive effects and ordinarily require no further analysis;" and "Mergers involving an increase in the HHI of less than 100 points are unlikely to have adverse competitive effects and ordinarily require no further analysis." On the other hand, the sentence setting up these statements is "When using HHI measures, the Agencies employ the following general standards for the relevant markets they have defined: ..." Thus, a close reading suggests that there is no safe harbor because the Agencies can desist from "using HHI measures" for any particular proposed merger, and thereby render inapplicable the seeming safe harbor. Indeed, in section 6.1, the draft asserts: "The Agencies rely much more on the value of diverted sales than on the level of the HHI for diagnosing price effects in markets with differentiated products."

Perhaps that last quote is intended to refer principally to the lack of use of the HHI for the assessment of competitive effects in markets with differentiated products, without signifying that the HHI will be viewed as inapplicable to a test for safe harbor treatment where products are differentiated. And indeed perhaps it is the intention of the Agencies to give the guidance that there is (at least ordinarily) a concentration-based safe harbor.

If that is the case, and I would hope so, then I suggest plain language to that effect. For example, the sentence leading up to the assertions on the HHI thresholds ("When using HHI measures, the Agencies employ the following general standards for the relevant markets they have defined: ...") could be replaced by this rewrite: "Whether or not HHI measures are used to assess competitive

effects in detail, they are applicable in relevant markets to the following broader assessments, including concentration-based safe harbors:..."

How Big is a SSNIP?

This reader is unable to discern how big is an ordinary SSNIP from the depth of section 4.1.2 of the draft. For example, suppose the merging parties are providers of services based largely on professional labor -- is the SSNIP intended to be 5% or 10% of the price of the services? For another example, suppose the merging parties manufacture and sell consumers' products based on their own designs and labor, but do acquire from others some of the parts, materials, energy and the factory equipment to a typical extent -- is the SSNIP 5% or 10% or some other percent (perhaps depending on value added?) of the price of the consumers' products? In my view, some clarification is much needed here.

Are HHIs Viewed as Useful for Analyzing Unilateral Competitive Effects in Markets for Homogeneous Goods?

The 2010 Guidelines draft is clear that HHIs are not the tool of choice for analyzing unilateral competitive effects in markets for differentiated products, and the draft is also clear that measures of market concentration are viewed as important to assessments of coordinated competitive effects. However, the draft seems silent on the applicability of measures of market concentration to assessments of unilateral competitive effects in markets for homogeneous products. Inasmuch as such mergers are not rare, and many mergers involve products that are only somewhat differentiated and otherwise homogeneous, it seems important for the draft to explain whether or not HHI analysis is viewed as useful to assessments of unilateral competitive effects in markets where differentiation is not of primary importance.

How to Analyze Unilateral Competitive Effects of a Merger Involving Differentiated Products?

The 2010 Guidelines draft is eloquent and clear in articulating the basic principles of unilateral competitive effects from a merger involving differentiated products. The draft echoes much of the '92 Guidelines on this subject appropriately, introduces the helpful terminology of diversion ratios, introduces the new tool called the "value of diverted sales," and then takes a step towards revolution by declaring: "The Agencies rely much more on the value of diverted sales than on the level of the HHI [in this domain]." This approach "need not rely on market definition or the calculation of market shares and concentration."

I feel that it is important to make three points at this juncture.

First, the value-of-diverted-sales is a potentially powerful new tool with a distinguished pedigree in the economics literature and solid support in professional economic logic. It is a measure of the added profit potential from a price increase that results from the proposed merger. As such, it

goes directly to the competitive effects of concern from a merger involving substitute differentiated products, in contrast to the indirect indications given by the level and delta of HHIs. The value-of-diverted-sales does not itself predict the sizes of the most profitable price increases from a merger, and the measure itself is apt to be altered, perhaps substantially, by the price changes at issue, by longer run rather than short run behavioral responses, and by rival repositioning. Such rich analytic issues are subjects of intense current research efforts, and answers to key theoretical questions are not yet predictable. Nevertheless, the approach surrounding value-of-diverted-sales commands this attention because it is so well founded in economics and it does have such promise. At its present somewhat nascent stage of refinement, value-of-diverted-sales is a welcome addition to merger analysis.

Second, as I discussed above, even with this new tool in hand, I do not think that obviating market definition is wise merger policy. The draft acknowledges the importance of analyzing the set of substitute products by declaring: "A merger is unlikely to generate substantial unilateral price increases if non-merging parties offer very close substitutes for the products offered by the merging firms." But this is well short of mandating the discipline of market definition and an assessment of impact on concentration and competition within the relevant market. It is my assessment that analysis of the relevant market is an important concomitant to the use of value-of-diverted-sales.

Third, and most important for present purposes, it must be said that the 2010 Guidelines draft is far too shy about the newly anointed tool termed the value-of-diverted-sales. The draft does not articulate at all how the Agencies calibrate this quantified measure. What constitutes a large enough value of diverted sales to raise substantial concerns? What is a small enough value of diverted sales to indicate that concerns about these competitive effects are unwarranted? To what should a measured value of diverted sales be compared?

The economics literature shows that the "upward pricing pressure" from the value-of-diverted-sales can be gauged by comparing (presumed or actual) marginal cost savings to the product of the diversion ratio and the margin between price and marginal cost. This is the only calibration of which I am aware for a measure of the value-of-diverted-sales. Yet, the Guidelines draft is completely silent on this subject. No quantitative or even qualitative framework is offered to disclose the Agencies' practices in this regard or to give guidance for business counseling. In view of the vital purposes of Agency Horizontal Merger Guidelines, I urge that the next version of the 2010 Guidelines provide guidance on how to use the new central tool for assessing unilateral competitive effects of mergers involving differentiated products.

How Much Entry Is Enough?

Section 9 of the draft Guidelines is elegantly articulate on the "timely, likely and sufficient" principles that are the foundations for the analysis of entry in reaction to a merger. However, perhaps unintentionally, by far the most specific guideline in this entire explanation is: "The

Agencies normally look for reliable evidence that entry will be sufficient to replicate at least the scale and strength of one of the merging parties." This would be highly inappropriate and inconsistent with the foundational principles if taken literally as a guideline for the entry phase of merger analysis. After all, it would be an extremely unusual competitive effect of concern that would eliminate the entire beneficial activities of one of the merging parties, or suppress output in total as much as the entire premerger output of one of the merging parties. And only in such rare and extreme circumstances would entry that would be sufficient to counteract the competitive effects of concern need to be "sufficient to replicate at least the scale and strength of one of the merging parties." Thus, what the draft now says is what the Agencies "normally look for" is, even in theory, implausible as a conceivable response to a merger, and well beyond what economic logic would say is the right guideline for adding specificity to the "timely, likely and sufficient" standard. Since this is the only specific guideline for how to do entry analysis in the draft (in contrast to the highly detailed specifications given for entry analysis in the '92 Guidelines), and since on its face it is so inappropriate, it would be best just to drop it.

This discussion raises the broader issue of whether the 2010 Guidelines should provide more practical guidance for analysis of entry. The '92 Guidelines was quite specific in suggesting time frames for entry to be considered "timely," and methodology comparing minimum viable scale to measures of business opportunity in the event of the exercise of market power by the merging parties. The purposes of the 2010 Guidelines would be advanced if more details were provided of how the Agencies actually do, or aspire to do, their entry analyses.

Rapid Entry Should Also Be Flexibly Reversible

For a firm that is not currently producing relevant products to be considered a market participant accorded a market share, that firm should be able easily and rapidly to commence production of relevant products in reaction to a SSNIP, and also able easily and rapidly to cease production of relevant products as prices recede to pre-merger levels. That is why such a firm is already a participant in the market, with a share indicated by its capacity profitably to produce relevant products as pricing warrants. In the '92 Guidelines, such firms are called "uncommitted entrants" to emphasize their ease of exit as well as their ease of entry, and the analytic test for this status is the insignificance of the sunk costs (less than 5% of all costs or of all revenues) they need to spend to commence production of relevant products. In the draft 2010 Guidelines, I believe this same idea is intended to be carried forward by the category of "rapid entrants:" "Firms [rapid entrants] that are not current producers in a relevant market, but that would very likely provide rapid supply responses with direct competitive impact in the event of a SSNIP, are also considered market participants." (Section 5.1) The draft language would be fully consistent with economics, in my view, and with the treatment in the '92 Guidelines if the defining sentence were slightly modified this way: "Firms [rapid entrants] that are not current producers in a relevant market, but that would very likely provide rapid *and flexibly reversible* supply responses with direct competitive impact in the event of a SSNIP, are also considered market participants." Similarly, the formulation in Section 9 of the draft is: "Firms that would rapidly and easily enter

the market in response to a SSNIP are market participants and may be assigned market shares."
The corresponding alteration would be: "Firms that would rapidly, easily and reversibly enter the market in response to a SSNIP are market participants and may be assigned market shares."