Hogan Lovells

Hogan Lovells US LLP
Columbia Square
555 Thirteenth Street, NW
Washington, DC 20004
T +1 202 637 5600
F +1 202 637 5910
www.hoganlovells.com

COMMENTS OF THOMAS B. LEARY AND JANET L. MCDAVID ON PROPOSED HORIZONTAL MERGER GUIDELINES

These comments express the personal views of the authors, based on their collective experience with merger matters while serving both private and public interests. They do not necessarily reflect the views of the Hogan Lovells firm or any of its clients.

We previously published in a variety of websites[1] an overview of the draft Horizontal Merger Guidelines, titled "New Merger Guidelines Emphasize Flexibility." The overall conclusion was that these Guidelines "provide a more accurate description of agency practice in recent years," but "do not evidence an intention to make radical changes...." We also commented favorably on the thoughtful analyses reflected in the draft and the transparent description of the way the Agencies actually review potential mergers. We still adhere to these views. In the interim, however, a number of questions have been raised by other informed observers, and these comments offer what are intended to be some constructive suggestions for improvement.

Sources of Tension

It is literally impossible to draft Guidelines that will please everyone. For example, thoughtful people may have very different views about the relative risks of over-enforcement and under-

1 One of these articles is attached. The differences among the articles are minor.

enforcement. These views are based in large part on differing value judgments that cannot be resolved by rational discourse. Our perception is that the draft Guidelines do not tilt strongly in one direction or the other. They continue to emphasize economic considerations, to the exclusion of more nebulous social and political concerns, an approach that we believe is appropriate. Some changes, like the reduced emphasis on precise market definition in Sec. 4, may make it easier for prosecutors to prove some cases. But, a more flexible approach to market definition and the consequences of concentration, could benefit the merging parties, as well – depending on particular facts. Since we agree that the Agencies should focus on competitive effects, we agree with the reduced emphasis on market definition and statistical calculations of market shares.

In fact, the most significant contribution of the new Guidelines is not a change in the overall balance, whatever it may be, but an overt recognition that merger analysis is not just a statistical exercise. The Guidelines state at the outset (Sec. 1) that "[m]ost merger analysis is necessarily predictive;" that "certainty about competitive effect is seldom possible;" and that it is necessary to "apply a range of analytical tools." Potential "non-price" effects, which may be difficult to quantify – "including reduced product quality, reduced product variety, reduced service, or diminished innovation" – are also more explicitly recognized. Many of these factors have been the subject of extensive Agency review in a number of transactions.

The need for transparency makes it appropriate for the Agencies to give greater emphasis to various sources of qualitative evidence. The economic justification for the changes is the continued rapid movement of consumer purchases away from more-or-less fungible commodities, which are relatively simple to model, toward the purchase of highly differentiated services and experiences, which are difficult to capture in numbers. It was probably inevitable that these fundamental insights would prompt criticism from both directions. Some have expressed concern that the new Guidelines are not sufficiently rigorous or objective; others comment that there still is too much emphasis on economic calculations. Some criticism seems to advance both positions simultaneously.

In summary, we appreciate that Guidelines are not just statements of principles, which hopefully will be widely accepted, but also an outline of the way that the Agencies actually intend to analyze mergers. The following comments proceed on the assumption that the Guidelines are intended simply to inform as well as persuade, but nevertheless offer several mild suggestions that may more clearly express what the agencies actually will do, and also may help to reduce controversy.

Suggested Revisions

(1) The statement about the probable root causes of prices "well above marginal cost" in Sec. 2.2.1 has probably attracted the most critical comment, because it neglects other important explanations. Any company with significant fixed costs, which is unable to engage in price discrimination, cannot survive for long unless it sets prices well above marginal cost. And, a substantial number of companies sell products with marginal costs that are essentially zero, but nevertheless operate in a competitive environment. Finally, a number of companies – particularly those with multiple product lines in a highly competitive marketplace – may not undertake rigorous determinations of their various marginal costs. They follow internal accounting rules that are applied across the board. Year-to-year consistency is more important than accurate measures of economic margins because business decisions are also driven by other considerations. (The inability to reach sweeping conclusions about competition from a study of internally generated profit margins for individual products is one reason why the FTC was unable to secure a mandate for Line of Business reports in the early 1970s.)

Since the statement about marginal returns in the Guidelines is both inaccurate and unnecessary, the simplest fix would be simply to delete it. An alternative would be to expand the discussion, and acknowledge that margins well above cost may have difference causes and call for difference approaches

For example, marginal costs may be relatively easy to identify in those businesses where products are bought and resold in their original form. Here, high margins across the board may indeed result from successful (and possibly legal) cooperation; high margins of a single company may indicate that it has successfully differentiated itself, and faces a relatively inelastic demand. In these situations, the acquisition of a potentially disruptive competitor may raise concerns if it merely preserves the existing high margins. Exclusive focus on likely price increases will result in false negatives.

On the other hand, in high tech industries like computers or pharma, profit margins tend to be high because R&D costs are high. In the entertainment field or minerals exploration, margins of the "winners" may be high because there are so many "losers." Indiscriminate use of margins to predict higher prices will result in false positives.

(2) The initial statement in Sec. 4.1.1 that "the hypothetical monopolist test" is used to determine "relevant antitrust markets" is overly broad, and needs to be qualified. There are a number of independent reasons.

First, it is not an accurate description of how the agencies operate. The statute does require a demonstrated effect in a geographic area or product space that is substantial enough to be a matter of federal concern. In the vast majority of cases, however, markets are not defined precisely from the ground up by this test. Simple reliance on precedent can be particularly important. For example, the FTC has historically defined the multiple product markets in pharmaceutical mergers by separate "therapeutic categories." Counsel for companies in the industry have been aware of this administrative practice, and are therefore able to "fix" their deals in advance. Practicality sometimes trumps precision. The Antitrust Division similarly engaged in rough cut market determinations when it had to deal with a blizzard of radio mergers in the 1990s.

Experienced counsel are aware of the importance of precedent, or customer consensus, in particular industries. They recognize that the SSNIP test is an expression of pure economic logic, which is necessarily based on simplifying assumptions and estimates – much like its twin, the "critical loss" calculations that support the theory of unilateral effects. (More on this later.) But, less experienced counsel or business executives – who are perhaps most in need of guidance – could mistakenly interpret this initial statement, and the later fulsome description of the SSNIP test, as a description of the effort they need to undertake before they notify a deal.

Finally, there is some internal inconsistency between this characterization of the SSNIP test and later statements about the significance of market definition. The SSNIP test implicitly assumes that there is a <u>single</u> relevant product and geographic market that can be determined rigorously. Historically, the test represented a strong reaction to what was considered a sloppy reliance on alternative markets and sub-markets in the populist era of antitrust, and the definition of a relevant market provided a useful discipline. But these new Guidelines sensibly recognize that "defining a market to include some substitutes and exclude others is inevitably a simplification . . . Relevant markets need not have precise metes and bounds." (Sec. 4) Moreover, the possibility that markets can in some cases be narrowly "defined around . . . targeted customers" (Sec. 4.1.4) directly raises the possibility that there can be more than one relevant market. For example, one broader "market" for the bulk of the firms' customers may suggest that a merger is benign overall, but the presence of a narrower "market" for targeted customers may suggest a need for some targeted relief.

In light of these qualifications, the agencies may want to consider whether such an extensive treatment of the SSNIP test is really appropriate. It also would be desirable to include a caveat in the Guidelines that any relevant market has to include a "substantial" number of customers or volume of commerce. Most mergers will cause some inconvenience or expense to someone, but Section 7 of the Clayton Act is limited to transactions that "substantially . . . lessen competition."

(3) Section 5.3 cautions that market concentration may be measured by "using the number of significant competitors" under certain circumstances. It goes on to say that the "combined market share of the merging firms" can be important standing alone "as an indicator" of the markets ability to replace the direct competition that is lost. It would be useful both to expand and to qualify this statement, either here or in the later discussion of entry where the concept also has relevance. (The data that the Agencies have published about the number of competitors, pre- and post-merger provide a useful illustration of the way some mergers have been analyzed.)

It is not unusual for parties to defend a proposed merger on the grounds that there will be significant economies of scale and that, in any event, price increases are unlikely because other incumbents can readily expand or new competitors can easily enter. There is an obvious tension between these claims, and it might be useful to point out that the caveat about combined market shares is particularly significant if scale economies are important. On the other hand, the market shares that need to be "replaced" may be less significant if non-price effects, like reduced innovation or quality are the concern.

(4) The new Guidelines recognize that precise delineation of relevant markets, market share calculations, and concentration ratios cannot supply a uniformly objective standard for predicting the likelihood of competitive effects. These changes will hopefully reduce the likelihood of lengthy arguments over statistical arcanae. However, there is some expressed concern that the detailed technical discussion of Unilateral Effects in Sec. 6 will give rise to similarly lengthy statistical controversies.

The reference to "economic models," plural, should help to clarify that the Guidelines do not endorse any single methodology (Sec. 6.4). But, it would be desirable to go further and acknowledge – as the Guidelines do in other contexts – the inherent uncertainties of estimates and simplifying assumptions. As mentioned, data on profit margins are often not available. Estimates based on past diversion ratios may assume that companies have in the past relied on information that they actually did not have, and further that these companies and their rivals will continue to employ the same competitive strategies in a future environment that will, by definition, be significantly transformed.

We do not offer any specific word changes, to address this concern – we are certain that other comments will do so. We simply suggest that the Agencies be mindful of the prevalent uneasiness and add further qualifiers to dispel any illusion of precision. As draft Guidelines acknowledge, the Agencies have a range of tools for considering competitive effects, and the choice depends on the nature of the deal and the availability of reliable data.

(5) The treatment of efficiencies in Section 10 does evidence a greater willingness to credit fixed cost savings. We recommend that the Agencies expand on this point. For reasons mentioned when we discussed marginal costs above in another context, the traditional emphasis on marginal cost improvements was unduly restrictive.

(6) The draft Guidelines create the impression in Section 12 that the analysis of buyer power and the analysis of seller power are largely symmetrical. But, buyer power cases are extremely rare, and that asymmetry is likely to continue. If this impression is correct, it might be desirable to warn the Bar explicitly that it will not be helpful to highlight enhanced purchasing "clout" as a likely merger efficiency.

(7) It does make sense to note in Sec. 13 the possible adverse effects on the behavior of firms that acquire a non-controlling interest in a rival. The Agencies have actually done so in some cases, and there is a sound economic rationale for it. It would be desirable, however, to explain how this analysis works, because the traditional focus has been on the future behavior of the acquired firm.

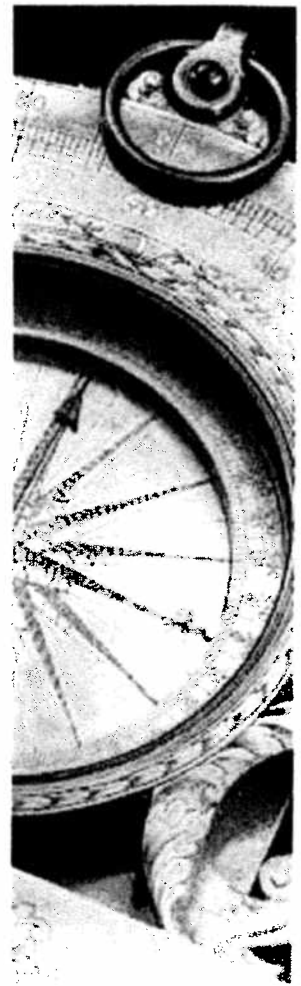
Conclusion

We emphasize again that the new Horizontal Merger Guidelines more accurately describe the agencies' current approach than the 1992 version does, and also reflect more advanced economic learning. They make a positive contribution and are worthy of support.

We appreciate the opportunity to make these modest suggestions for your consideration

ANTITRUST UPDATE

HOGAN & HARTSON



New Merger Guidelines Emphasize Flexibility

The Department of Justice Antitrust Division and the Federal Trade Commission (the Agencies) have just released for public comment a new draft of Horizontal Merger Guidelines, the first major revision since 1992. The draft will disappoint those who anticipated major changes in direction, and reassure those who feared them.

The new Guidelines continue to rely on economic factors, and do not revive the populist policies of the 1960's and early 1970's. However, they also emphasize (Section 1) that "merger analysis is necessarily predictive;" that absolute precision in merger analysis, therefore, is not possible; and that statistical calculations are not the only sources of economic wisdom. The Agencies will "consider many sources of evidence" (Section 2.2).

This candid acknowledgement of a more holistic, indeed subjective, approach will not surprise experienced counsel, who have long recognized that the technical economic inquiries articulated in the 1992 Guidelines did not necessarily reflect actual practice. The judicial response is more difficult to predict, however, in light of increasing insistence on rigorous economic proof in some recent decisions.

This article will examine some significant changes in more detail.

(1) Less Emphasis on market definition, calculation of shares and concentration. Successive versions of previous Merger Guidelines, published in 1982, 1984 and 1992, have progressively given less weight to market concentration statistics. However, these Guidelines continued to assume that the first step in merger analysis would be the definition of a "relevant market." In the 1992 Guidelines, the appropriate calculations were discussed immediately after the introductory paragraph (Section 1). But in the new draft Guidelines, these statistical matters are deferred until Section 4, after an extended discussion of other sources of information about economic consequences, including the informed views of merger parties, customers and analysts (Section 2).

Moreover, Section 4 states at the outset: "Market definition is not an end in itself: it is one of the tools . . . ." Competitive analysis "need not start with market definition." Product and geographic markets may occupy a spectrum of both close and more distant substitutes. "[D]efining a market to include some substitutes and exclude others is inevitably a simplification ...."

If market definition is an imprecise inquiry (a point on which we agree), it obviously makes sense to further reduce the emphasis on market definition and market shares. The new Guidelines raise the

HOGAN & HARTSON

HHI thresholds between "unconcentrated," "moderately concentrated," and "highly concentrated" markets to levels more consistent with agency practice, but note that the presumptions from increased concentration enhance the likelihood of serious agency review.

A reduced emphasis on markets and shares may meet with some judicial resistance. However, counsel should welcome this more realistic approach. If generally accepted, it could have a salutary impact on the way that mergers are investigated and litigated. Today, vast time and resources can be consumed in arguments over a market definition and market share calculations, which thereafter may play only a limited role in the final decision.

(2) Reduced Focus on Predicted Price Increases.

The traditional focus on likely price increases has been modified. When markets are defined, for example, agencies will still apply the so-called "SSNIP" test. (Section 4.1.1.), which defines a market as the smallest product and geographic space within which a hypothetical monopolist "likely would improve at least a small but significant and non-transitory increase in price." But, if it is not always necessary to define markets rigorously, these hypothetical predictions may also be unnecessary.

Another shift flows from the articulation of a "unifying theme" that mergers should not be permitted to create, enhance, or entrench market power (Section 1). The word "entrench," which does not appear in the 1992 version, signals that an anticompetitive effect can be found – even absent a likely price increase – if the merger would make it easier for the surviving company simply to maintain already high prices that might otherwise be expected to fall (See Section 4.1.2).

The extended discussion of "non-price" effects also modifies the prior Guidelines' almost-exclusive concern about likely price increases, which again was not always consistent with agency practice. Injury from non-price effects was briefly acknowledged in the 1992 Guidelines (Section 0.1 n. 6), but is given greater emphasis in Section 6.4 of the new Guidelines, titled "Innovation and Product Variety." It is also noteworthy that proof of adverse effects on innovation do not depend on definition of an "innovation market," which is a difficult and controversial concept.

(3) Shift in Emphasis from "Coordinated Effects" to "Unilateral Effects".

The 1982 and the 1984 Guidelines focused exclusively on the increased likelihood of either explicit or implicit cooperation among competitors after a merger. Concern about adverse "unilateral effects" resulting from the post-merger conduct of a single firm was first introduced in the 1992 version, in a section that followed discussion of coordinated effects (Sections 2.1, 2.2). The new Guidelines discuss unilateral effects first, and at greater length (Sections 6, 7), because it is more often applied by the Agencies today.

(a) Unilateral Effects

Greater emphasis on unilateral effects can further reduce the need for market definition or concentration calculations, because these inquiries may not be necessary. (See Section 6.1) This theory of competitive harm is relatively easy to articulate: If the producer of one

HOGAN & HARTSON

product acquires a close substitute product, it may have an incentive to increase prices on one of them because some of the resulting lost sales will be captured by the substitute. A prediction of whether this may actually happen, however, requires estimates of sales lost by the product subject to a hypothetical price increase; the percentage of these lost sales likely to be captured by the newly acquired product; and the future incremental profit margins on both. Confidence in these predictions depends on the availability of data.

The new Guidelines do not endorse any specific technique for these calculations, and acknowledge that there may be a number of alternative "economic models" and other "available and reliable information" that will be relevant to the analysis. Thus the agencies have a "tool box" of alternative analytical techniques and will choose the appropriate tool based on the facts of each transaction and the nature of the data available. It is possible that resources saved by reducing the emphasis on market definition and market shares will be diverted in some cases to disputes over alternative calculations of unilateral effects.

(b) Coordinated Effects

Reduced reliance on market definition and market concentration statistics will diminish the relative importance of coordinated effects. However, the new guidelines do provide one useful caveat: "[t]he higher the HHI level, the greater is the likelihood that the Agencies will request additional information . . . .." (Section 5.3) This statement seems to recognize the concept of a "sliding scale," which holds that the burdens of defense are roughly keyed to the strength of the prosecutor's case -- another example of a more flexible, and more realistic, approach.

There also is implicit recognition of the fact that coordination does not have to be perfect in order to be harmful. The 1992 Guidelines emphasized that successful coordination depends on the ability to detect and punish deviations (Sections 2.1, 2.12). The new version emphasizes various other factors that may enhance or inhibit coordination (Sections 7.1-7.2), and thus recognizes that the effect can be present in varying degrees.

(4) Less Technical Definitions of Entry

The new Guidelines eliminate the semantically confusing distinction between "uncommitted" and "committed" entrants in the 1992 version. So-called "rapid entrants" can be included in the initial market definition (Section 5.1), without the unrealistic expectation that their entry (or exit) would be virtually costless.

In addition, the "actual history of entry" is "given substantial weight." (Section 9) This recognizes current practice and, if used with discretion, could be a less burdensome and controversial inquiry than calculations of what potential entrants might do in hypothetical circumstances. Lack of past entry has little predictive value, however, if the industry has changed fundamentally. Moreover, absence of entry at pre-merger prices does not preclude the real possibility that entry will discipline price increases post-merger.

HOGAN & HARTSON

The three significant elements of "timeliness, likelihood, and sufficiency of the entry" are also cast in less technical terms, and the arbitrary two-year test for timeliness has been eliminated. Since the old two-year test might also be viewed as sufficient proof of timeliness, its elimination could favor prosecutors in some circumstances. But, overall, it makes better sense to weigh the three elements together rather than specify individual hurdles.

(5) Little Change in Discussion of Efficiencies

The close correspondence between efficiencies language in this version and the 1992 version is itself noteworthy, in light of heightened skepticism about business acumen after the 2008 crash. There is some greater willingness to credit fixed cost savings. Conversely, predicted lower prices are discounted if accompanied by "reductions in product quality or variety." (Section 10)

(6) Monopsony Power

The draft Guidelines include a discussion of the potential issues raised by mergers of competing buyers, which can enhance market power on the buying side of the market. The draft states that the agencies use "essentially the [same] framework" for evaluating such mergers. Monopsony issues have arisen most often in transactions involving health insurers and in agriculture.

(7) Partial Acquisitions

Although partial acquisitions have been the subject of enforcement actions at both agencies, the draft Guidelines for the first time discuss the potential competitive effects of such acquisitions, which include giving a minority owner the ability to influence the competitive conduct of the target firm, reduced incentives to compete because of profits gained through the minority interest, and the exchange of competitively sensitive information, which may facilitate coordination.

Conclusion

The new draft Guidelines provide a more accurate description of actual agency practice in recent years. They do not evidence an intention to make radical changes in merger analysis. The increased emphasis on economic evidence that cannot readily be captured by statistics may look like a retreat from purely objective agency determinations. But, some subjective judgments are inevitable and have always been present – and dramatic changes are tempered by the influence of long-term career staff and by the oversight of courts, which tend to rely on precedent. The avoidance of lengthy upfront disputes over market definition, with attendant calculations, might appear to favor the Agencies, and greater flexibility could have an adverse effect on predictability. However, the more holistic approach also creates opportunities for defense counsel with good stories to tell. The future level of merger activity is likely to be driven, as it has been, by general economic conditions and by government regulations other than antitrust.

About this Antitrust Update

Hogan & Hartson frequently publishes the Antitrust Update, which covers the latest global news and developments in competition and antitrust issues. For further information regarding the issues raised in this update, please contact one of the lawyers below or any other member of Hogan & Hartson's Antitrust, Competition and Consumer Protection Group.

HOGAN & HARTSON

JANET L. MCDAVID
jlmcdavid@hhlaw.com
+1.202.637.8780
Washington, D.C.

THOMAS B. LEARY
tbleary@hhlaw.com
+1.202.637.5662
Washington, D.C.

www.hhlaw.com