Project No. P092900

COMMENTS

of

THE WASHINGTON LEGAL FOUNDATION

to the

FEDERAL TRADE COMMISSION

Concerning

REQUESTS FOR COMMENTS REGARDING THE PROPOSED HORIZONTAL MERGER GUIDELINES RELEASED APRIL 20, 2010

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Submitted Electronically
Federal Trade Commission
Office of the Secretary
Room H-135 (Annex P)
600 Pennsylvania Avenue, N.W.
Washington, DC 20580.

Re: Horizontal Merger Guidelines Review Project – Comments
Project No. P092900
Proposed Guidelines Released April 20, 2010

Dear Sir/Madam:

The Washington Legal Foundation (WLF) submits these comments in response to the Federal Trade Commission's Proposed Horizontal Merger Guidelines released on April 20, 2010. WLF believes that the proposed Guidelines, in their discussion of unilateral effects analysis for differentiated products, do not take sufficient account of the role of the relevant market. WLF fears that under the proposed Guidelines, unilateral effects will be found to exist virtually any time that merging firms sell closely related products. Indeed, the proposed Guidelines state that a merger may produce significant unilateral effects for those products even when it is anticipated that an increase in the price of one of those products would result in a significant majority of sales being diverted to products sold by non-merging firms.

WLF submits that the proposed Guidelines do not take sufficient account of likely competitive responses to the merging firms. Competitors in differentiated product industries typically are very adept at repositioning their products to capture share from consumers dissatisfied by voids in the marketplace created by the merger – whether in the form of unilateral price increases or decreases in service. While pre-merger consumer surveys may demonstrate that the first two choices of a sizable number of consumers are two products provided by the merging firm, competitive responses to the merger very often will bring about rapid changes in those preferences. Accordingly, in the absence of significant barriers to entry, the merging firms in most cases will not be able to increase profits by unilaterally increasing prices of one or both of their products. WLF also submits that the proposed Guidelines are insufficiently precise regarding the level of anticipated unilateral effects that will trigger a presumption that a merger is anticompetitive.

I. *Interests of the Washington Legal Foundation*

The Washington Legal Foundation is a public interest law and policy center based in Washington, D.C., with members and supporters in all 50 States. WLF devotes a substantial portion of its resources to defending free enterprise, individual rights, and a limited and accountable government. To that end, WLF has frequently appeared as *amicus curiae* in the federal courts to address the proper scope of the antitrust laws. *See, e.g., Pacific Bell Tel. Co. v. linkLine Communications, Inc.*, 129 S. Ct. 1109 (2009); *Weyerhaeuser Co. v. Ross-Simmons Hardware Lumber Co.*, 549 U.S. 312 (2007); *3M Co. v. LePage's, Inc.*, 324 F.3d 141 (3d Cir. 2003), *cert. denied,* 542 U.S. 953 (2004); *Feesers, Inc. v. Michael Foods, Inc,* 591 F.3d 191 (3d Cir. 2010).

WLF believes that the object of the antitrust laws should be to promote competition and thereby provide consumers with better goods and services at lower prices. WLFs believes that some mergers thwart competition by eliminating not-easily replaced competitors and thereby allowing the merged entity to exercise market power. But antitrust experts have long since recognized the fallacy of a big-is-bad enforcement policy – a policy generally espoused not by consumer advocates but by rival entities unable to compete with the merged entity. As the FTC recognizes, mergers often create efficiencies that ultimately provide benefits to consumers, in the form of lower prices, increased output, or increased innovation. The FTC carries out its function appropriately when it guards against mergers whose effect would be to substantially lessen competition or create a monopoly. WLF believes, however, that the FTC performs a disservice to consumers if it discourages firms from contemplating beneficial mergers by adopting Guidelines that frown on virtually all mergers between firms that produce one or more highly similar products.

II. FTC's Statutory Authority

Antitrust law in the United States originated with the Sherman Act, which prohibited "every contract, combination . . . , or conspiracy, in restraint of trade," and attempts "to monopolize any part of the trade or commerce." 15 U.S.C. §§ 1-2. Subsequently, § 7 of the Clayton Act provided that mergers subject to the Clayton Act are prohibited if their effect "may be substantially to lessen competition, or to tend to create a monopoly." 15 U.S.C. § 18. The purpose of the Sherman Act "was the prevention of restraints to free competition in business and commercial transactions which tended to restrict production, raise prices, or otherwise control the market to the detriment of purchasers or consumers of goods and services, all of which had come to be regarded as a special form of public injury." *Apex Hosiery Co. v. Leader*, 310 U.S. 469, 493 (1940). The Clayton Act provided that restraints of trade are not prohibited unless they constitute a "substantial" lessening of competition. A merger is deemed likely to "create a monopoly" if it brings a suspected monopolist "substantially closer" to the "power to exclude competition when

the monopolist desires to do so." *United States. v. du Pont*, 353 U.S. 586, 592 (1957). The Supreme Court has emphasized that the "[s]ubstantiality" of lessened competition "can be determined only in terms of the market affected." *Id.* at 593.

The Hart-Scott-Rodino Antitrust Improvements Act of 1976 requires persons (including corporations) to notify the FTC and the Assistant Attorney General for the Antitrust Division of potential stock acquisitions of another corporation that exceed certain thresholds found in 15 U.S.C. § 18a. The companies seeking to merge must then wait 30 days following notification before the stock acquisition can be transacted. The notifications must "be in such form and contain such documentary material and information relevant to a proposed acquisition as is necessary and appropriate to enable the Federal Trade Commission and the Assistant Attorney General to determine whether such acquisition may, if consummated, violate the antitrust laws." 15 U.S.C. § 18a(d)(1) (2006). The FTC or the Antitrust Division may also issue a "second request" for information if a merger is of particular interest. If either agency concludes after its preliminary review that the proposed merger will violate the antitrust laws, it may file suit in federal court and seek to enjoin the merger.

III. The Current Guidelines

The current version of the Horizontal Merger Guidelines were issued in April 1992 and revised in April 1997. As they currently stand, the Guidelines are meant to "articulate the analytical framework the Department of Justice and the FTC (the "Agency") apply in determining whether a merger is likely substantially to lessen competition"; a principal goal is "to reduce the uncertainty associated with enforcement of the antitrust laws." 1992 Horizontal Merger Guidelines §§ 0.-0.1. The "unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise," because "the result of the exercise of market power is a transfer of wealth from buyers to sellers or a misallocation of resources." *Id.* § 0.1.

The Guidelines attempt to provide courts and businesses with a step-by-step understanding of the Agency's assessment of mergers. Under the current Guidelines, the FTC or Antitrust Division first defines a relevant market and assesses whether the merger will increase concentration beyond an acceptable level in that market. Second, it assesses whether the merger raises concerns about potentially adverse competitive effects. Third, the Agency assesses whether entry into the market would be sufficiently easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels. Fourth, the Agency assesses whether the merger has the potential to generate efficiencies by permitting a better utilization of existing assets, thereby allowing the firm to reduce production costs (cost savings that would likely lead to lower prices). The ultimate determination is whether the merger will create or enhance market power.

In assessing the potential adverse competitive effects of a merger, the Guidelines provide that the Agency will examine unilateral effects; that is, whether the merging firms may find it profitable to alter their behavior unilaterally following the merger, by elevating prices and suppressing output. The Guidelines explain that substantial unilateral price elevation is unlikely unless there is "a significant share of sales in the market accounted for by consumers who regard the products of the merging firms as their first and second choices, and . . . repositioning of the non-parties' product lines to replace the localized competition lost through the merger [is] unlikely." *Id.* § 2.21. But the Guidelines emphasize that "market concentration affects the likelihood that one firm, or a small group of firms, could successfully exercise market power." *Id.* § 2.0. The Guidelines indicate that the Agency is less likely to object to a merger based on potential unilateral effects where the market is not highly concentrated (as measured by the Herfindahl-Hirschman Index ("HHI")) and the merging firms have a combined market share of less than 35%. *Id.* § 2.211.

IV. The Proposed Guidelines

The proposed Guidelines eschew the methodical approach of the current Guidelines. Instead, the proposed Guidelines provide that "merger analysis does not consist of uniform application of a single methodology." Proposed Horizontal Merger Guidelines § 1. The proposed Guidelines state that a merger will be deemed to "enhance[] market power if it is likely to encourage one or more firms to raise price, reduce output, diminish innovation, or otherwise harm customers as a result of diminished competitive constraints or incentives." *Id.* They drastically reduce the role of market definition in the merger evaluation process. While the proposed Guidelines provide guidance regarding how relevant markets are to be defined and their concentration measured, they emphasize that conclusions surrounding market definition and concentration are to be treated as nothing more than one factor among many to be used in determining whether a proposed merger would reduce competition. The proposed Guidelines also make clear that unilateral effects analysis is to play a significantly expanded role in the Agency's determination regarding a merger's effect on competition. Indeed, they provide that the Agency may rely solely on a unilateral effects analysis to determine a merger's potential anticompetitive effects, without any requirement that the Agency first define a relevant product market. *Id.* § 6.

V. The Evolution of Unilateral Effects Analysis

Over the past two decades, unilateral effects analysis has become any increasingly favored tool for understanding the anticompetitive implications of a potential merger. Unilateral effects analysis purports to measure the extent to which a merged firm may be able to raise prices unilaterally because the merger has eliminated sources of competition. The most obvious example of this is a merger to monopoly by two firms selling homogenous products.

However, the proposed Guidelines also define several other "common types" of unilateral effects. These include a merger between two firms selling fundamentally different products which act as the next closest substitute for each other; a merger between two sellers that normally compete for the same buyer through an auction or bidding process; and a merger that is likely to encourage the merged firm to curtail its innovative efforts below the level that would prevail in the absence of the merger. *Id.* §§ 6.1 – 6.4.

Of particular concern to WLF is the first mentioned type – unilateral effects occurring in mergers involving differentiated products. The theory has intuitive appeal but can be very difficult to apply fairly and accurately. When two firms sell differentiated products that serve as close substitutes for one another, a merger of those firms can raise anticompetitive concerns, according to theory, because the merged firm can now raise the price of one product yet will be able to capture some of the lost sales – they will merely be diverted to the product of the merger partner. In such a situation, "the potential incentive to increase price post-merger arises from the ability of the merged firm to recapture, through the sale of the merger partner's product, some of the sales that would otherwise be lost as a result of any such price increase." Gopal Das Varma, Gary Roberts, & Yianis Sarafidis, *Evolution of Unilateral Effects Analysis and the Road Ahead*, THE THRESHOLD, Fall 2009, at 11 [hereinafter "*Evolution*"]. The extent to which the merged firm can unilaterally raise prices is said to be based on the substitutability of the two products, as measured by the "diversion ratio," that is, the "fraction of the reduction in the sales of one product following a unilateral price increase that is captured by the other product." *Id.* at 15. The higher the diversion ratio and the variable margins earned on each product, the theory goes, the greater is the incentive for the merged firm to unilaterally raise prices.

VI. By Establishing a Unilateral Effects Analysis That Is Largely Divorced From Market Definition, the Proposed Guidelines Are in Tension Antitrust Law

The Proposed Guidelines, by significantly de-emphasizing the importance of defining the relevant market and its level of concentration when determining whether market power exists, are in considerable tension with current antitrust case law. Federal courts have repeatedly recognized market definition as an indispensable first step when addressing the propriety of horizontal mergers. For example, the U.S. Court of Appeals for the District of Columbia Circuit stated that the FTC's ability to demonstrate that a challenged merger would produce anticompetitive effects hinged entirely on the proper definition of the relevant product market. *FTC v. Whole Foods Mkt.*, 548 F.3d 1028, 1043 (D.C. Cir. 2008) (Tatel, J., concurring). Although the FTC had argued that market definition was only a means to an end and not an essential part of its case, the D.C. Circuit stated that only through examination of a particular market can the "probable anticompetitive effects of the merger be judged." *Id.* at 1036 (Tatel, J., concurring) (quoting *Brown Shoe Co. v. United States*, 370 U.S. 294, 322 n.38

(1962)). Indeed, a *prima facie* case that the defendants' conduct is likely "to lessen competition" (in violation of § 7 of the Clayton Act, 15 U.S.C. § 18) "rests on defining a market and showing undue concentration in that market." *Id.* (citing *United States v. Baker Hughes Inc.*, 908 F.2d 981, 982-83 (D.C. Cir. 1990). In *Chicago Bridge Iron Co. v. FTC*, 534 F.3d 410 (5th Cir. 2008), the Fifth Circuit agreed that "[t]ypically the Government establishes a *prima facie* case by showing that the transaction in question will significantly increase market concentration, thereby creating a presumption that the transaction is likely to substantially lessen competition." *Id.* at 423. Neither court indicated that the FTC could prove its case merely by establishing that the merging firms sold differentiated products that were close substitutes, without also showing that the relevant market was sufficiently concentrated. *See also United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1117 (N.D. Cal. 2004) ("In a unilateral effects case, a plaintiff is attempting to prove that the merging parties could unilaterally increase prices. Accordingly, a plaintiff must demonstrate that the merging parties would enjoy a post-merger monopoly or dominant position, at least in a 'localized competition' space."); *FTC v. CCC Holdings, Inc.*, 605 F. Supp. 2d 26, 68 (D.D.C. 2009).

The existence of market competitors inevitably places constraints on a seller's ability to raise prices unilaterally. Where a market consists of only two firms that wish to merge, clear anticompetitive concerns arise. However, the FTC's apparent willingness to challenge a merger between two firms selling differentiated products alleged to be close substitutes, with little regard for other market participants, in effect defines a market around those two products. That two products may serve as close substitutes for one another does not necessarily imply a lack of competition elsewhere in the market. The proposed Guidelines state that the analysis "need not rely on market definition or the calculation of market shares and concentration." Proposed Guidelines § 6.1. But even if non-merging firms do not currently offer very close substitutes for the products offered by the merging firms, the existence of numerous competitors within an existing market is highly relevant to the likelihood that non-merging firms will reposition their products to offer close substitutes for the products offered by the merging firms. Unless the Agency begins by calculating market share and concentration, it is unlikely to fully consider the likelihood that non-merging firms will quickly begin selling close substitutes:

> There is a natural tension between the relatively broad market definitions frequently adopted by the Courts and the use of market definition based screens to establish presumptions regarding unilateral effects. In order to resolve or reduce this tension, the Guidelines' treatment of unilateral effects will need to pay attention to both the extent of direct competition between the merging parties and the implications of the broader market in which they both compete. While direct evidence (or inferences based on existing margins and diversion ratios) may be important considerations, it is critical that these factors be evaluated in the broader context of a well defined market.

Evolution at 25.

Unilateral effects analysis may suggest that a merger of two firms selling differentiated products will result in the merged firm having the incentive to raise prices, but without detailed analysis of other market constraints on those products' prices, over-enforcement may occur. As the current Guidelines recognize, "Substantial unilateral price elevation in a market for differentiated products requires that there be a significant share of sales in the market accounted for by consumers who regard the products of the merging firms as their first and second choices, and that repositioning of the nonparties' product lines to replace the localized competition lost through the merger be unlikely." § 2.21. Therefore, it is important to understand not only the extent of consumers' willingness to substitute the merged firm's goods under current market conditions, but also their willingness to do so under market conditions likely to exist following the merger. Only with an understanding of the relevant market can the true effects of entry and repositioning be understood:

> Often the most important part of unilateral effects analysis is understanding the likely competitive responses to the merged firm. Competitive brand repositioning can greatly deter a firm from exercising unilateral market power, or can minimize its effects. Competitors in differentiated products industries are typically adept at product positioning and will often be able to adjust to fill any void in the marketplace resulting from the merger by repositioning current brands or offering new products designed to capture share from consumers dissatisfied with existing choices. Accordingly, the [current] Guidelines expressly require an analysis of the "ability of rival sellers to replace lost competition." This mandates an understanding of the relevant market, and of the firms participating in it. The same is true for assessing entry conditions, also an important part of unilateral effects analysis.

James F. Rill, *Product Differentiation: Practicing What They Preach: One Lawyer's View of Econometric Models in Differentiated Products Mergers*, 5 GEO. MASON L. REV. 393, 398 (1997).

The proposed Guidelines acknowledge that the Agency will examine the likelihood that other firms will enter the market in response to the merging firm's attempt to raise prices. Proposed Guidelines § 9. But they do so grudgingly, and with a bias that suggests that the Agency will view most such efforts as untimely, unlikely, or insufficient to render a price increase profitable. *Id.* WLF respectfully suggests that the Agency very often will underestimate the likelihood of entry unless it undertakes a careful evaluation of the relevant market and its concentration. While market definition may not be necessary to detect the incentive a merged firm will have to raise prices unilaterally, its actual ability to do so very much depends on the competitive environment in which it operates. David Scheffman &

Joseph Simons, *Unilateral Effects for Differentiated Products: Theory, Assumptions, and Research*, THE ANTITRUST SOURCE, Apr. 2010, http://www.abanet.org/antitrust/at-source/10/04/Apr10-Scheffman4-14f.pdf ("[M]ore attention needs to be paid in the typical differentiated products merger to what constrains the prices of the parties to the merger. The fundamental issue in the analysis of potential unilateral effects arising from a merger of differentiated products is what constrains the prices of the relevant products."). The proposed elimination of the requirement that the Agency carefully define the market and evaluate its concentration is an unfortunate backward step.

VII. The Proposed Guidelines Should Provide More Detailed Guidance Regarding Which Mergers Are Likely to Be Deemed Anticompetitive

Because mergers so often produce pro-competitive effects, WLF believes that antitrust enforcers must exercise restraint before stepping in to block mergers. Such enforcement action is a blunt instrument to be used sparingly, and should be resorted to only when the evidence suggests that anticompetitive effects are extremely likely. Indeed, "[w]hen a particular form of behavior is too complex for reliable analysis, then the only defensible antitrust rule is to let the market rather than the courts control." Herbert Hovenkamp, THE ANTITRUST ENTERPRISE: PRINCIPLE & EXECUTION 47 (2005). Even as the tools for measuring the effects of mergers evolve, regulators will always be operating under information deficiencies. Unilateral effects analysis of differentiated products is not immune from the uncertainties created by such information deficiencies; multiple scholars have recognized that effective analysis depends to a great extent on access to a large quantity of data surrounding the merger. Moreover, the FTC should not lose sight of the fact that antitrust enforcement, like all forms of government regulation, is subject to regulatory capture in which "disgruntled rivals try to exploit the law." Robert A. Levy, *The Case Against Antitrust* (The Cato Institute, Nov. 2004), available at http://www.cato.org/pub_display.php?pub_id=2894. Regulators should not delude themselves into viewing unilateral effects analysis as an invincible tool that justifies reinvigoration of antitrust enforcement; they instead should carefully consider the strong possibility that expanded reliance on such analysis is simply a stalking horse for those who fear the increased competition often brought about by horizontal mergers.

WLF is concerned that increased reliance by the Agency on unilateral effects analysis, especially concerning markets with differentiated products, will lead to greater but unnecessary antitrust enforcement. As one scholar has recently pointed out, use of an upward price pressure test (a test proposed to measure unilateral effects) may lead to over enforcement:

> If the UPP test were to replace the structural presumption in the agencies' merger reviews, more mergers would likely be subject to additional scrutiny. The mergers likely to be in this group are those where the merging firms' products constitute first and second

> choices for a large fraction of their pre-merger buyers but their shares of sales in the industry in question are relatively small and there are no bright line market boundaries to be drawn within the industry. In those cases, the approaches to market definition used in practice are likely to lead to broad markets. Accordingly, the market concentration and market share thresholds for a structural presumption are less likely to be triggered. However, diversion ratios between the merging firms' products will be sufficiently high to result in significant upward pricing pressure and the failure of the UPP test.

Gopal das Varma, *Will Use of the Upward Pricing Pressure Test Lead to an Increase in the Level of Merger Enforcement?*, 24 ANTITRUST 27, 30 (2009).

This critique suggests that antitrust enforcement may increase based on unilateral effects analysis in which diversion ratios are *high*. Unfortunately, the proposed Guidelines do not even require high diversion ratios. Instead, the proposed Guidelines merely note that higher ratios indicate a higher likelihood of anticompetitive effects. Indeed, the proposed Guidelines indicate that "a merger may produce significant unilateral effects for a given product even though many more sales are diverted to products sold by non-merging firms than to products previously sold by the merging partner." Proposed Guidelines § 6.1. When an analysis of *existing* market conditions indicates that a price increase would cause most lost sales to be diverted to the products of non-merging firms, WLF views it as unrealistic for regulators ever to assume that the likelihood of unilateral effects; under those circumstances, the high likelihood that competitors would reposition their products in response to the market void render any regulatory intervention wholly unwarranted. The Agency is creating considerable uncertainty in the business community by suggesting that it may contemplate intervention even when diversion ratios are quite low. That uncertainly is likely to cause businesses to forgo mergers that would have pro-competitive effects. To avoid such an outcome, the Agency should provide greater certainty by establishing minimum diversion ratios; the Guidelines should provide that the Agency will not interfere with a proposed merger based on a unilateral effects analysis for differentiated products, if it concludes that the diversion ratio falls below the minimum.

WLF submits that to increase transparency and to prevent an overextension of the antitrust laws, the Agency needs to better define, within the unilateral effects analysis, what market conditions will cause it to conclude that a proposed merger will have anticompetitive effects. Moreover, WLF strongly believes that any such analysis should be based *solely* on market conditions. WLF deems it wholly inappropriate to base regulatory action on statements of executives of the merging firms. That executives hope that a merger will allow them to raise prices has little bearing on whether market conditions will allow them to do so. Every executive wants to increase profits and at all times is exploring avenues for doing so – including the possibility of price increases. To use written statements to that effect as an excuse for blocking proposed mergers is an abandonment of sound economic analysis and a return to the discredited

big-is-bad approach to antitrust enforcement.

Just as the HHI index helps to add a measure of objectivity to the analysis of market concentration, setting forth ranges of diversion ratios that create presumptions of anticompetitivemess can only serve to increase transparency and guidance for courts and the business community at large.

CONCLUSION

WLF applauds the Agency in its attempt to increase public understanding of its approach to horizontal merger analysis. WLF respectfully requests that the proposed Guidelines be revised along the lines recommended in these comments. WLF urges the Agency to continue to recognize the importance of understanding the relative market surrounding mergers and the constraints that in the great majority of cases will prevent unilateral price increases. The Agency should also consider defining further, or giving estimations, of what activities, when subject to a unilateral effects analysis (particularly for differentiated products) will lead to presumptions of anticompetitive behavior.

Sincerely,

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