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U.S. Antitrust Agencies Propose Full-Scale Revision Of Horizontal Merger Guidelines

I. Introduction

On April 20, 2010, the Federal Trade Commission ("FTC") and the Antitrust Division of the U.S. Department of Justice ("DOJ," and, together with the FTC, the "Agencies") jointly issued for public comment a full-scale revision of the Horizontal Merger Guidelines (the "Guidelines").[1] The Guidelines spell out the analytical framework under which the Agencies assess mergers between competitors. The Agencies announced a joint effort to review and revise the Guidelines in October 2009, and held five workshops to solicit the views of the antitrust bar, economists, and other interested parties. The new proposed Guidelines (the "Proposed Guidelines") represent the first end-to-end revision of the Guidelines since 1992. Public comments will be accepted until May 20, 2010.

Reflecting Existing Agency Practice, a Flexible and Integrated Analysis

The Agencies' enforcement practices have evolved significantly over the last 18 years, and the Proposed Guidelines are largely designed to reflect the existing practice of the Agencies. For the most part, the framework, tools, and practices outlined in the Proposed Guidelines are well known to the antitrust bar and economists. As a result, in most cases the Guidelines should not result in significant changes to the existing regulatory process for merger review. In fact, several aspects of the Proposed Guidelines were previewed in the Agencies' March 2006 Commentary on the Horizontal Merger Guidelines ("2006 Commentary").[2]

A central theme of both the 2006 Commentary and the Proposed Guidelines is that the Agencies will conduct a flexible, integrated analysis of the likely competitive effects of a transaction. The analysis is flexible because there are many tools available to assess mergers, and selecting the most appropriate tool or tools for analyzing any particular transaction often depends upon the circumstances of the particular case. The analysis is often described as "integrated" because the Agencies look at the totality of the evidence on all issues, and form a judgment on the transaction's likely net effect on competition. This is an intentional change from the 1992 Guidelines, which many viewed as creating a rigid five-

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1 Available at: http://www.ftc.gov/os/2010/04/100420hmg.pdf.

2 Available at: http://www.justice.gov/atr/public/guidelines/215247.htm.

step process. In particular, the Proposed Guidelines place less emphasis on market definition, market shares, and concentration, and more emphasis on competitive effects.

A Pro-Enforcement Economic Tilt, and an Eye to the Courts

As one would expect, the Proposed Guidelines bear the distinct imprint of the Agencies' chief economists, Carl Shapiro (DOJ) and Joseph Farrell (FTC). Both are highly respected economists that have written extensively on issues related to merger enforcement, and both have supported a policy of active enforcement. While the Proposed Guidelines generally reflect mainstream economic analysis, in some respects they help establish a foundation for greater enforcement. For example, the Proposed Guidelines support narrowly defined markets, and suggest that the Agencies should carefully consider potential harm to localized competition (for instance as a result of price discrimination against targeted customers). In addition, the Proposed Guidelines place new emphasis on the importance of analyzing profit margins. For example, the Proposed Guidelines suggest that industries exhibiting high variable margins are unlikely to be fully competitive, and the Proposed Guidelines focus on margins in connection with key types of economic analysis, such as critical loss analysis (for market definition) and the analysis of "upward pricing pressure" ("UPP") for unilateral effects in differentiated products.

Despite these changes, we believe that the Proposed Guidelines are unlikely to result in significant modifications to current Agency practice. In our view, the more important long-term impact of the Proposed Guidelines is likely to take place (if at all) in the courts. Many courts applied the 1992 Guidelines as a strict set of hurdles that the Agencies must clear in pursuing a merger challenge. With the Proposed Guidelines, it appears that the Agencies are seeking to lower this bar and to move away from court precedent that had made it difficult for Agencies to prevail in federal court. It remains to be seen whether courts will follow this invitation and jettison the more rigid 1992 Guidelines. Decades of court precedent, along with the text of Section 7 of the Clayton Act (which requires that the Agencies show a substantial lessening of competition "in any line of commerce or in any activity affecting commerce in any section of the country") suggest that the courts may be unlikely, for example, to allow the Agencies to forgo defining product and geographic markets. *See*, *e.g.*, *Brown Shoe Co. v. U.S.*, 370 U.S. 294, 324 (1962). We will closely watch the Agencies' and the courts' evolving approaches to these issues.

II. <u>Shift to a More Flexible and Integrated Analysis</u>

As noted, the Proposed Guidelines represent a shift away from the rigid five-step analytical process set out in the 1992 Guidelines: (1) product and geographic market definition, (2) calculation of market shares and market concentration, (3) analysis of competitive effects, (4) an investigation of potential entrants, and (5) the balancing of verifiable efficiencies against the expected anti-competitive harm. The Proposed Guidelines make clear that the Agencies will not employ such a formulaic approach going forward:

> These Guidelines should be read with the awareness that merger analysis does not consist of uniform application of a single methodology. Rather it is a fact-specific process through which the Agencies, guided by their extensive experience, apply a range of analytical tools to the reasonably available and reliable evidence to evaluate competitive concerns in a limited period of time.

The Proposed Guidelines state that the goal of the Agencies is to analyze, using whatever facts and tools are available, whether a transaction creates, enhances, or entrenches market power. In fact, the first section of the Proposed Guidelines is not market definition, as in the 1992 Guidelines, but rather a review of the varied types and sources of evidence that the Agencies consider. Moreover, the Proposed Guidelines place a much greater emphasis on describing the Agencies' approach to the analysis of anti-competitive effects, particularly unilateral effects.

De-emphasis of Market Definition and Concentration

Perhaps the most significant departure from the 1992 Guidelines is the treatment of market definition. While the general approach to defining markets (*e.g.*, use of the "hypothetical monopolist test") remains largely unchanged, the importance of the market definition exercise itself is significantly reduced in the Proposed Guidelines. The Proposed Guidelines state that market definition is not an end, but rather a means to assess whether a merger may substantially lessen competition and as such is only "useful to the extent it illuminates the merger's likely competitive effects." The Proposed Guidelines further state that the analysis need not start with market definition and in some cases may not include market definition at all. For example, Section 6 of the Proposed Guidelines states: "Diagnosing unilateral price effects based on the value of diverted sales need not rely on market definition or the calculation of market shares and concentration." While this statement essentially reflects current practice at the Agencies, it would represent a significant change if followed by the courts, which have traditionally required the Agencies to prove market definition as a threshold issue. In addition, and on a related note, the Proposed Guidelines de-emphasize market concentration (which can only be measured after the market is defined). The Proposed Guidelines describe concentration as merely "one useful indicator" regarding likely competitive effects.

III. <u>Other Notable Updates to the 1992 Guidelines</u>

We summarize below some of the other important changes included in the Proposed Guidelines.

Price Discrimination

The Proposed Guidelines provide substantial new guidance on potential harm to targeted customers, including through price discrimination. The 1992 Guidelines covered these topics in the market definition section and elsewhere, but the Proposed Guidelines create a new section to address these topics in greater detail. The Proposed Guidelines also address price discrimination in other sections, which is not surprising because the possibility of price discrimination influences nearly all aspects of merger analysis, including market definition, the measurement of market shares, and the evaluation of competitive effects. (For example, when price discrimination is present, the Agencies may define markets and evaluate competitive effects separately by type of customer.)

The Proposed Guidelines' focus on price discrimination is consistent with the Agencies' intent to define markets narrowly and identify competitive concerns in narrow segments of broader markets. The new price discrimination section of the Proposed Guidelines may also suggest skepticism about the ability of new entry or re-positioning of existing competitors to mitigate concerns about a loss of localized competition.

Unilateral Effects

The length of this section has doubled from the 1992 Guidelines. This change likely reflects the importance the Agencies place on investigating and analyzing unilateral effects, as well as the significant development of experience and economic analysis over the last 18 years. The Proposed Guidelines now split this section into separate discussions of the pricing of differentiated products, bargaining and auctions, capacity and output for homogenous products, and innovation and product variety.

Within the "pricing of differentiated products" section, the Proposed Guidelines specifically discuss a number of technical economic tools, including diversion ratios, UPP analysis, and merger simulation models.

The UPP analysis merits particular focus. It is relatively new, and the Agencies' chief economists have specifically advocated the UPP approach both before and after they assumed their current positions. The UPP test attempts to quantify the increased incentive of merging firms to raise the price of at least one of their competing products post-merger. For example, pre-merger, if firm A increased the price of its product, it may be likely that some customers would have diverted their purchases to firm B's competing product. After a merger of A and B, the combined firm would re-capture any such diverted sales, increasing the incentive of the merged firm to raise price on firm A's product. The UPP analysis attempts to quantify this change in incentives by focusing on the margins of each product and the closeness of competition between the two products.

Market Definition

As discussed above, the market definition section primarily focuses on the hypothetical monopolist test employed in the 1992 Guidelines. As before, a key aspect of the test is consideration of how customers will respond to a small but significant and non-transitory increase in price or "SSNIP," *e.g.*, 5% or 10%. If enough customers will shift to products outside of the proposed relevant market to render the SSNIP unprofitable for the hypothetical monopolist, the proposed market is deemed too narrow. The Proposed Guidelines contain a lengthy discussion of the implementation of the SSNIP test, four aspects of which are worth highlighting:

First, the market definition section explicitly prefers narrow markets. After noting that it is better to err on the side of excluding distant substitutes, the Proposed Guidelines also state that "[m]arket shares of different products in narrowly defined markets are more likely to capture the relative competitive significance of these products, and often more accurately reflect competition between close substitutes."

Second, the Proposed Guidelines specifically note that, when the data are available, the Agencies may consider conducting a "critical loss analysis." Critical loss analysis attempts to quantify whether imposing a SSNIP on a product in the proposed relevant market would raise or lower the hypothetical monopolist's profits. An increase in price raises profits on sales made at the higher price, but it also leads to lost sales. This test determines and compares (1) the critical loss, *i.e.*, the level of lost sales that would leave profits unchanged, and (2) the predicted loss, *i.e.*, the loss of sales predicted as a result of the proposed price increase. Importantly, and not surprisingly, the discussion reflects DOJ chief economist Carl Shapiro's writings regarding margins and critical loss analysis. Among other things, the Proposed Guidelines note that "high pre-merger margins [of price to "variable" or incremental cost] normally indicate that each firm's product individually faces demand that is not highly sensitive to price." This observation may be of particular concern to industries with high up-front sunk costs and low marginal costs, such as software and pharmaceuticals.

Third, the geographic market definition section is restructured. This section now places on equal footing two possibilities – that geographic markets can be defined by either the location of suppliers or the location of customers. Previously, the focus was on the location of suppliers, and geographic markets defined by the location of customers were treated as an exception to the rule, occurring only in the presence of price discrimination. This change could make it easier for the Agencies to litigate a merger challenge involving a geographic market based on the location of customers.

Fourth, there is a notable change to the implementation of the SSNIP test. The test is no longer applied to the price of the product or services sold, but rather to the "value contributed" by the relevant industry to the product or services sold. For example, if an industry purchases an input for $90, transforms it a bit, and sells it for $100, the SSNIP test would be whether the $10 "contribution to value" (rather than $100 price) could be profitably increased by 5-10%. This change will lead to narrower markets if the Agency could demonstrate that a hypothetical monopolist could profitably raise price by 50 cents or $1, but could not show that it could profitably raise prices by $5 or $10.

Market Concentration

In measuring market concentration, the Proposed Guidelines continue to employ the Herfindahl-Hirschman Index ("HHI"). The HHI is calculated by summing the squares of individual firms' market shares. The Agencies will review both the post-transaction HHI as well as the change in HHI created by the transaction. The 1992 Guidelines established standards for the employment of HHI, which the Proposed Guidelines update to better reflect actual practice:

Market Concentration	1992 Guidelines – Post-Merger HHI Thresholds	Proposed Guidelines – Post-Merger HHI Thresholds	Competitive Concerns?
Unconcentrated Markets	< 1000	< 1500	Unlikely
Moderately Concentrated Markets	1000 – 1800; HHI increase of < 100	1500 – 2500; HHI increase of < 100	Unlikely
	1000 – 1800; HHI increase > 100	1500 – 2500; HHI increase > 100	Potentially raises significant concerns
Highly Concentrated Markets	> 1800; HHI increase of < 50	> 2500; HHI increase < 100	Unlikely
	> 1800; HHI increase of 50 – 100	> 2500; HHI increase 100 – 200	Potentially raises significant concerns
	> 1800; HHI increase > 100	> 2500; HHI increase > 200	Presumed likely to enhance market power

Even with these changes, the HHI standards in the Proposed Guidelines still may not fully reflect the Agencies' actual practice. The Agencies' own analysis of past merger challenges indicates that most challenges occur at HHIs above 3000 rather than 2500.

While the 1992 Guidelines placed caveats around the ability of market shares and HHI analysis to predict anti-competitive transactions, some commentators still treated the thresholds as creating safe harbors. As a result, the Proposed Guidelines explicitly state that the thresholds do not create such bright line rules:

> The purpose of these thresholds is not to provide a rigid screen to separate acceptable mergers from anticompetitive transactions, although high levels of concentration do raise concerns. Rather, they provide one way to identify those mergers for which it is particularly important to examine whether other competitive factors confirm, reinforce, or would counteract the potentially harmful effects of increased concentration.

Entry

The entry section remains largely the same, with a focus on whether entry will be timely, likely, and sufficient to deter the proposed anti-competitive effects of a transaction. The one notable change is the absence of the two-year timeframe for entry. The 1992 Guidelines indicated that the Agencies generally would consider timely only entry that could be completed within two years, but the Agencies have at times objected that this period is too long a horizon over which to evaluate competitive effects, at least in some industries. In particular, the Agencies may be seeking to reduce the likelihood that judges will treat two years as a "safe harbor." Consistent with the overall theme of increased flexibility, the Proposed Guidelines do not mention any specific timeframe for timely entry.

Innovation and Other Non-Price Competition

The Proposed Guidelines make clear that, in measuring competitive effects of a transaction, the Agencies consider effects not only on pricing, but also on innovation, product quality and product variety. Section 6.4 of the Proposed Guidelines, for example, discusses whether a merger is likely to diminish innovation competition. In this regard, the Proposed Guidelines indicate that the Agencies will review how a transaction is likely to affect the merged firm's incentives. This detailed treatment of innovation did not exist in the 1992 Guidelines.

Proposed New Sections

The Proposed Guidelines highlight in new sections a number of additional issues relevant to the merger review process, including:

- a detailed description of the types and sources of evidence the Agencies will rely on to evaluate potential adverse competitive effects;

- an explanation of the role of powerful buyers, which have the ability to resist price increases following mergers;

- mergers of competing buyers, which can create market power on the buying side (often referred to as monopsony); and
- acquisitions in which a company (*e.g.*, a private equity firm) acquires partial ownership of competing businesses.

IV. **Conclusion**

The Proposed Guidelines provide a significant update to the nearly twenty-year-old Guidelines, aligning them better with current agency practice. But there are also many subtle but important changes that should be carefully reviewed on a case-by-case basis for mergers involving significant competitive issues.

Perhaps the most important impact of the new Guidelines may be on the analysis of merger challenges by the courts. Courts will need to decide how to balance the Proposed Guidelines with case law citing, among other things, the rigid tests outlined in the 1992 Guidelines. It remains to be seen whether the courts will accept the broad flexibility set forth in the Proposed Guidelines, particularly in light of established court precedent and statutory authority.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Antitrust and Competition in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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