CPI Antitrust Journal

October 2010 (2)

The Framework of the 2010 Horizontal Merger Guidelines

Paul T. Denis

Dechert LLP

The Framework of the 2010 Horizontal Merger Guidelines

Paul T. Denis[1]

I. INTRODUCTION

The two principal reasons that the 1992 Horizontal Merger Guidelines[2] achieved longevity, judicial acceptance, and international imitation were: (1) for the most part, it asked the right questions; and (2) it provided a structured framework in which to ask those questions.[3] If those attributes of the 1992 Guidelines are viewed as evaluative criteria against which to judge any revisions, the 2010 Horizontal Merger Guidelines[4] are a mixed bag.

The revised Guidelines evidence a decided move away from asking the "right" questions, substituting for those questions a greater exposition on the direction of antitrust merger analysis, the general principles underlying it, and some of the tools that might be employed in conducting that analysis. The additional exposition adds explanatory power at a general level but probably spells an earlier obsolescence for the final document. Predictions of the demise of the structured framework appear to have been premature. The framework remains largely intact even while the Agencies attempt to side-step the statutory requirement of market definition.

II. ASKING THE RIGHT QUESTIONS

The "right questions" to ask in merger analysis are those that elicit facts that determine whether the conditions necessary to establish that a merger is likely to create or enhance market power, or facilitate its exercise, are met in any given transaction. The 2010 Guidelines move away from asking the "right questions" by generally removing from the Guidelines the notion that anything is necessary to establish the market power effects of a merger. A host of issues are identified as potentially relevant to analyzing a given situation, and a variety of tools that might be employed are suggested, but none are regarded as necessary in any particular situation. Many of the familiar bright line tests of the 1992 Guidelines have been removed or obscured. In their place, there is a greater exposition of the factors and tools that may be relevant to analyzing mergers and the evidence that may be considered.

The removal of bright line tests and necessary conditions is particularly prominent in the treatment of entry. While retaining the timeliness, likelihood, and sufficiency framework employed in the 1992 Guidelines, the 2010 Guidelines redefine each of these elements to eliminate bright line tests and conditions necessary to establish that entity will deter or counteract

---

[1] Paul T. Denis, Co-Chair of the Antitrust/Competition Practice at Dechert LLP, was the principal draftsman of the 1992 Horizontal Merger Guidelines, represented the defendant in FTC v. Whole Foods Market, Inc., and currently represents the defendant in United States and Plaintiff States v. Dean Foods Company. He can be reached at paul.denis@dechert.com.

[2] Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (1992, revised 1997), *available at* http://www.justice.gov/atr/public/guidelines/hmg.htm ("1992 Guidelines").

[3] For a more detailed analysis of these and other reasons, see *Denis, Horizontal Merger Guidelines: A Draftsman's Perspective,* GCP: THE ANTITRUST CHRONICLE (December 2009).

[4] Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (August 2010), *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.html ("2010 Guidelines").

the competitive effect of concern. The table below quoting from the 1992 and 2010 Guidelines illustrates the contrast in approach.

	1992 Guidelines	2010 Guidelines
Timeliness	[T]he Agency will consider entry to be timely so long as it would deter or counteract the competitive effects and concern within the two-year period and subsequently. § 3.2.	In order to deter the competitive effect of concern, entry must be rapid enough to make unprofitable overall the actions causing those effects and thus leading to entry, even though those actions would be profitable until entry takes effect. § 9.1.
Likelihood	[E]ntry is unlikely if the minimum viable scale is larger than the likely sales opportunity available to entrants. § 3.3.	Entry is likely if it would be profitable accounting for the assets, capability and capital needed and the risks involved, including the need for the antitrust to incur costs that would not be recovered if the entry later exits. Profitability depends upon [post-merger output, prices and costs]. § 9.2.
Sufficiency	[C]ommitted entry generally will be sufficient to deter or counteract the competitive effects of concern whenever entry is likely. § 3.4.	Even when timely and likely, entry may not be sufficient to deter or counteract the competitive effect of concern. § 9.3.

Conceptually it is difficult to argue with the 2010 Guidelines formulation for any of the three elements of entry. But those elements are now stated at such a high level of generality that they fail to indentify the conditions necessary to conclude that entry will deter or counteract the competitive effect of concern. The 2010 Guidelines treatment of entry educates the reader about entry analysis and illuminates the issues surrounding it. But the task of education and illumination is better left to a document like the *Commentary on the Horizontal Guidelines.*[5] Because the 2010 Guidelines ultimately fail to ask the right question, they fall short of providing meaningful guidance.

Similarly in competitive effects analysis, the 2010 Guidelines move away from bright line tests and necessary conditions.

The 1992 Guidelines treatment of unilateral competitive effects in homogeneous product markets made a 35 percent combined share a necessary condition. A combined share of less than 35 percent was a safe harbor that precluded pursuit of a unilateral effects theory.[6] But the 2010 Guidelines remove the necessary condition/safe harbor and replaces it with a series of directional considerations:

> A unilateral output suppression strategy is more likely to be profitable when (1) the merged firm's market share is relatively high; (2) the share of the merged firm's output already committed for sale at prices unaffected by the output suppression is relatively low; (3) the margin on the suppressed output is relatively low; (4) the supply responses of rivals are relatively small; and (5) the market elasticity of demand is relatively low.[7]

In the treatment of unilateral competitive effects in differentiated products markets, the 1992 Guidelines stopped short of necessary conditions but, instead, established a presumption of unilateral effects where "each product's market share is reflective of not only its appeal as a first choice to consumers…but also its relative appeal as a second choice, and hence as a competitive constraint to the first choice."[8] In practice this 35 percent threshold became a necessary condition to pursuing a differentiated products unilateral effects case and combined shares below 35 percent were regarded a creating a safe harbor precluding pursuit of a unilateral theory. But the 2010 Guidelines back off of even this statement, instead offering only that "[s]ubstantial unilateral price elevation post-merger for a product formerly sold by one of the merging firms normally requires that a significant fraction of the customers purchasing that product view products of formerly sold by the other firm as their next best choice."[9] But "significant" is not defined other than to say that it "need not approach a majority" unless pre-merger margins between price and incremental cost are low.[10]

One set of bright line tests that may have survived are the concentration-based safe harbors. In the April draft, the Agencies appeared to be moving away from the notion that market concentration could be a safe harbor and that it was necessary to establish that the merger would significantly increase concentration in a moderately or highly concentrated market in order to conclude it would have adverse competitive effects. The April draft stated that:

> [t]he purpose of these thresholds is not to provide a rigid screen to separate acceptable mergers from anticompetitive transactions . . . Rather, they provide one way to identify those mergers from which it is particularly important to examine whether other competitive factors confirm reinforce, or counteract the

---

[5] Department of Justice and Federal Trade Commission, Commentary on the Horizontal Merger Guidelines (2006) *available at* http://www.justice.gov/atr/public/guidelines/215247.htm.

[6] 1992 Guidelines § 2.22.

[7] 2010 Guidelines § 6.3.

[8] 1992 Guidelines § 2.211.

[9] 2010 Guidelines § 6.1.

[10] *Id.*

> potentially harmful effects of increased concentration."[11] The 2010 Guidelines now concede that concentration also provides a way to identify "some mergers unlikely to raise competitive concerns.[12]

Whether this signals a continued safe harbor role for concentration remains unclear. But the safe harbor may be one in name only since elsewhere in the 2010 Guidelines the Agencies take the position that market definition may be inferred from competitive effects evidence. When you consider that some classes of economic models will suggest adverse competitive effects from any merger where the products of the merging firms are closest substitutes for even just a single consumer, there is not much safety in the safe harbor and proof of concentration is no longer a meaningful necessary condition.

While the 2010 Guidelines may not ask the "right questions" in the sense of necessary conditions they do provide considerably more information about merger analysis at a general level. An entire new section is devoted to the types of evidence that may be relied upon in merger analysis and the sources of that evidence.[13] The underpinnings of unilateral effects analysis are provided in greater and more clear detail than in the 1992 Guidelines, as are some potential applications of unilateral effects analysis in different market settings (differentiated products, bargaining and auction contexts, and homogeneous products).[14] For many, these expositions will welcome additions to the Guidelines. But for those looking for standards that can be applied rather than directional indicators, the new text is unsatisfying.

III. PROVIDE A STRUCTURED FRAMEWORK

The structured framework of the 1992 Guidelines largely survived the revision process although, as expected, the 2010 Guidelines now take the position that market definition can follow competitive effects analysis and can be inferred from competitive effects evidence. But this effort to avoid market definition as a separate element of the analysis appears unlikely to succeed in court since it ignores the statutory requirement that there be evidence that a <u>substantial</u> lessening of competition be likely and, further, that such effect be felt in a properly defined market.

The 1992 Guidelines provided structured or sequential process for analyzing mergers following five steps, each necessary and together sufficient to analyze the likely competitive effects of mergers: (1) market definition, measurement, and concentration, (2) competitive effects, (3) entry, (4) efficiencies, and (5) failing firm/division. Putting market definition first in the process was not a random choice. In addition to tracking the approach used by the courts in merger analysis since the inception of the Clayton Act, defining a market at the outset of the analysis provided a dimension over which substantiality could be measured.[15] Market definition quite properly became a "gating item" for the remainder of the analysis.[16]

---

[11] Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines § 5.3 (DRAFT April 2010), available at http://www.ftc.gov/os/2010/04/100420hmg.pdf ("April 2010 Draft").

[12] 2010 Guidelines § 5.3.

[13] 2010 Guidelines § 2.

[14] 2010 Guidelines § 4.

[15] The Section 7 of the Clayton Act requires that the efficiency of a merger may be <u>substantially</u> to lessen competition. (Emphasis supplied).

[16] Concurring Statement of Commissioner J. Thomas Rosch on the Release of the Horizontal Merger Guidelines, Project No. P092900 (August 19, 2010) (criticizing the notion that market structure evidence acts as a gating item), *available at* http://www.ftc.gov/speeches/rosch/100819horizontalmergerstatement.pdf

In practice, the courts' insistence on market definition as a gating item and the inability to prove alleged product markets led to frustrating losses in cases such as *United States v. Oracle Corp*.[17] and *FTC v. Whole Foods Market, Inc*.,[18] where the Agencies believed there was strong evidence of competition effects.

The 2010 Guidelines attempts to deal with this problem by asserting that "[t]he Agencies' analysis need not start with market definition." Instead, the 2010 Guidelines suggest that the agencies, in effect, could back into market definition from evidence of competitive effects:

> Evidence of competitive effects can inform market definition, just as market definition can be informative regarding competitive effects. For example, evidence that a reduction in the number of significant rivals offering a group of products causes prices for those products to rise significantly can itself establish that those products form a relevant market. Such evidence also may more directly predict the competitive effects of a merger, reducing the role of inferences from market definition and market shares. Where analysis suggests alternative and reasonably plausible candidate markets, and where the resulting market shares lead to very different inferences regarding competitive effects, it is particularly valuable to examine more direct forms of evidence concerning those effects.[19]

But this approach begs the question: How does one know that a reduction in the number of significant rivals causes prices to rise? Particularly in the case of proposed mergers, how can the Agencies know what will happen in the future?

Apparently the Agencies have great confidence in various tools that might be employed in competitive effects analysis. But tools such as the upward pricing pressure model ("UPP") which is given official recognition in Section 6 of the Guidelines, and other unilateral effects theories based on Bertrand oligopoly models, predict a price elevation from every merger where the products of the merging firms are the closest substitutes for at least one consumer. To infer market definition from this sort of effects "evidence" is to read market definition out of the statute, something that neither Agencies nor the courts have the power to do.

Backing into market definition from competitive effects evidence also ignores the statutory requirement of establishing a substantial lessening of competition. Where competitive effects analysis is divorced from market definition, as the 2010 Guidelines suggest the Agencies may do, there is no assurance that the effects being measured are substantial. The academic paper underlying the upward pricing pressure model appeared to recognize this problem by proposing a "standard deduction" at 10 percent to ensure that some threshold of substantiality was applied.[20] Both the case law and the predecessor Guidelines handled the substantiality requirement by insisting that the challenged effects occur in the context of a well-defined market among firms of a sufficient relative size that substantial adverse competition effects from the merger were plausible. The 2010 Guidelines provide no substantiality check.

Beyond the effort to reorder the place of market definition, the structured framework of the 1992 Guidelines remained largely intact. The purpose of entry analysis continues to be

---

[17] 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

[18] 502 F. Supp. 2d 1 (D.D.C. 2007), *rev'd*, 548 F. 3d 1028 (D.C. Cir. 2008).

[19] 2010 Guidelines § 4.

[20] Farrell & Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Alternative to Market Definition*, 10(1) B.E. J. Theoretical Econ. Article 9 at 10 (2010).

described as whether "entry will deter or counteract any competitive effects of concern,"[21] which presumes that the magnitude of these competitive effects of concern has been indentified or is assumed.

Efficiencies are credited in the analysis only if "cognizable [and] . . .of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market."[22] In other words, cognizable efficiencies must be "sufficient to reverse the merger's potential to harm customers in the relevant market, e.g., by preventing price increases in that market."[23] This analysis can only take place if the potential adverse competitive affects have first been identified or assumed.

Failing firm/division would change the conclusion that a merger was likely to cause adverse competitive effects only if, among other things, there was a process to select a reasonable alternative "that would keep the assets of the acquired firm in the relevant market and pose a less severe danger to competition than does the proposed merger."[24] As with efficiencies analysis, failing firm/division analysis can only take place if preceded by a competitive effects analysis that provides a benchmark against which alternatives transactions can be evaluated.

It is telling that the organization of the 2010 Guidelines continues to track the structured framework of the 1992 Guidelines with competitive effects analysis preceded by market definition, measurement, and concentration, and followed sequentially by entry, efficiencies, and filing firm/division. The drafting and organization of the 2010 Guidelines strongly suggest that various elements of merger analysis remain sequentially dependent on each other.

V. CONCLUSION

For some users, the 2010 Guidelines will be seen as a decided improvement, even if the revisions deviate from these evaluative criteria. For others, particularly more experienced users, the revisions may raise more questions than they answer. The longevity, acceptance, and future imitation of the 2010 Guidelines is likely to turn on how well agency practice and future public statements fill the gaps created by the revisions.

[21] 2010 Guidelines § 9.
[22] *Id.*
[23] 2010 Guidelines § 10.
[24] 2010 Guidelines § 11.