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U.S. Antitrust Agencies Issue New Merger Guidelines

The Department of Justice ("**DOJ**") and Federal Trade Commission ("**FTC**") recently issued the final revisions to the Horizontal Merger Guidelines (the "**2010 Guidelines**"). The agencies had issued draft revisions for comment on April 20, 2010. Davis Polk's summary and analysis of the original draft can be found here.

Overall, the final revisions closely track the original draft from April 2010. There are few substantive changes contained in the final version. In particular, the 2010 Guidelines retain the controversial "upward pricing pressure" test, which attracted significant commentary and some criticism in the original draft. The revised draft attempts to address some criticisms concerning the reduced emphasis on market definition in the Guidelines. It also contains some interesting further points on power buyers, geographic market definition, and other subjects.

Background

The previous Horizontal Merger Guidelines had remained unchanged since 1992, aside from the addition of a section on efficiencies in 1997. The Guidelines outline the process by which the FTC and the DOJ analyze the antitrust implications of horizontal mergers and acquisitions. (The Guidelines do not address vertical mergers and acquisitions.) The 2010 Guidelines are intended to "more accurately represent the agencies' [horizontal] merger review process."

Though the Guidelines have no force of law, they are highly influential. FTC Chairman Jon Leibowitz described the 1992 Guidelines as "one of the most cited documents in modern antitrust."

In most respects, the 2010 Guidelines are not "new" but, rather, reflect an effort to articulate the enforcement philosophy that is already ascendant in Washington, D.C. The revisions provide a more detailed description, with numerous examples, of the range of evidence that the agencies consider when evaluating the competitive effects of horizontal mergers, and further contain expanded discussions of factors such as innovation and product variety, coordinated effects, and market entry.

Key Revisions From the 1992 Guidelines

Below are some key highlights from the 2010 Guidelines (all of which remain basically unchanged from the April 2010 draft):

- The Guidelines downplay the importance of market definition in the horizontal merger analysis, stating that "[t]he measurement of market shares and market concentration is not an end in itself, but is useful to the extent it illuminates the merger's likely competitive effects." In recent years, the government's biggest court losses in horizontal merger cases (*Arch Coal/Triton*; *Oracle/People Soft*; and – at the district court level – *Whole Foods/Wild Oats*) have turned on market definition issues.
- The Guidelines, instead, place more emphasis on other empirical and theoretical ways to measure and predict anticompetitive effects, including: (i) merger simulation models (which "need not rely on market definition"); (ii) economic tests of "upward pricing pressure" (which also "need not rely on market definition"); (iii) the use of win/loss data; and (iv) "natural experiments." The "upward pricing pressure" (or "UPP") test was developed in academic articles by the current chief economists at the DOJ and FTC (Carl Shapiro and Joseph Farrell, respectively).
- Many of the economic models and tests outlined in the Guidelines (in particular, the UPP test) are very sensitive to the values of certain key inputs, including: (1) the profit margins earned by the merging firms (defined as price minus marginal or "incremental" cost); and (2) the "diversion ratio"

between products sold by the merging firms – that is, the fraction of unit sales lost by one product due to an increase in its price that would be diverted to a second product. In practice, there may be substantial questions about the proper values for these inputs – which may make the outputs of the models subject to doubt and debate.

- The 2010 Guidelines place significant emphasis on whether mergers will facilitate "price discrimination" against a subset of vulnerable customers. This approach may, in some cases, encourage very narrow market definitions comprised only of those customers.
- The Herfindahl-Hirschman Index ("**HHI**") thresholds have been upwardly revised.[1] The Guidelines state that the agencies will consider markets "unconcentrated" if, after the merger, they have a HHI below 1,500 (an increase from a threshold of 1,000). A market will be considered "highly concentrated" at a HHI of 2,500 or greater (an increase from 1,800). A merger producing (i) an increase of more than 200 HHI points and (ii) a post-merger HHI exceeding 2,500 will be presumed anticompetitive. The new thresholds, however, do not represent a loosening of horizontal merger review standards but, instead, conform the Guidelines to the thresholds that the agencies have most often used in practice.
- Further, the 2010 Guidelines delete the "safe harbor" provision, contained in the 1992 Guidelines, which provided that harmful unilateral effects of a horizontal merger would not arise so long as the merged firm had a market share of below 35%. This deletion makes the higher HHI thresholds described above much less significant.
- The Guidelines include a new section discussing the impact of horizontal mergers on innovation. The 1992 Guidelines focused primarily on short-term prices and output effects.
- Finally, the 2010 Guidelines include separate sections analyzing the effects of powerful buyers, mergers of competing buyers, and partial acquisitions.

Key Revisions From the April Draft Guidelines

A few notable changes were made to the 2010 Guidelines, from their original publication in draft form on April 20, including the following:

- The revised Guidelines attempt to address criticism that, by downplaying or ignoring market definition, they were inconsistent with established antitrust case law and the plain language of Clayton Act § 7, which requires a showing of injury to competition in a "line of commerce" or "any activity affecting commerce in any section of the country." The final Guidelines make it clear that the agencies will "normally" define relevant markets in enforcement actions:

  > *"[M]arket definition helps specify the line of commerce and section of the country in which the competitive concern arises. In any merger enforcement action, the Agencies will normally identify one or more relevant markets in which the merger may substantially lessen competition."*

- The revised Guidelines retain the "small but significant and non-transitory increase in price" ("**SSNIP**") test as a principal basis on which to define a relevant market's structure. The 2010

[1] The HHI is calculated by summing the squares of the individual firms' market shares, and thus gives proportionately greater weight to the larger market shares. For a market composed of 10 firms, each with 10% market share, the HHI would be 1000 (10^2 x 10).

Guidelines now state, however, that what constitutes a SSNIP "depends on the nature of the industry and the merging firms' positions in it" and that use of a "price increase that is *larger or smaller* than five percent" may be appropriate (emphasis added).

- The revised Guidelines contain expanded analyses of geographic markets. In particular, the Guidelines note that, in calculating market share, the agencies may base a foreign firm's share in a relevant, homogenous product market on its *capacity* to serve U.S. customers, rather than on its current sales to domestic customers.
- The revised Guidelines now state that the market value of an incumbent firm which far exceeds the replacement cost of its tangible assets may suggest high barriers to entry into a relevant market, because the value of that firm's intellectual property "may be difficult or time consuming for an entrant to replicate." Further regarding entry, the Guidelines now specifically point out that several firms entering the market each on a small scale may still be deemed "sufficient" entry to counteract anticompetitive effects of a merger.
- The revised guidelines note that the decision to eliminate a product post-transaction may be an efficient consolidation of products when variety offers little value to consumers, but in some circumstances may have anticompetitive effects when a significant number of consumers strongly prefer the product to be withdrawn.
- The revised Guidelines expand the discussion of "power buyers" by noting particular ways in which they can constrain and counteract anticompetitive conducts: "This can occur, for example, if powerful buyers have the ability and incentive to vertically integrate upstream or sponsor entry, or if the conduct or presence of large buyers undermines coordinated effects."

Practical Implications

- Overall, the 2010 Guidelines reflect a pro-enforcement perspective and an effort to blunt various tools that merging parties have used successfully in the past to defeat horizontal merger challenges.
- The agencies will take a particularly hard look at mergers between firms that sell similar products in differentiated product markets. They are likely to be less receptive to arguments in favor of broader market definitions and broader competitive dynamics. Win/loss data will be key in many deals as a measure of the closeness of competition between the merging parties.
- If the agencies set a high bar for non-merging firms' ability to reposition their products to offer close substitutes, the economic tests embodied in the 2010 Guidelines may lead to more horizontal merger challenges.
- The Guidelines appear to focus on firms with high margins (defined as a price "well above incremental cost"). While a footnote acknowledges that "high margins are not in themselves of antitrust concern," benign explanations for them are few, and are themselves contained only in footnotes.
- In technology industries, it will be increasingly important to convince the agencies that mergers will not harm innovation and product variety. However, these non-price competitive effects are discussed far less than price effects in the 2010 Guidelines, which provide no definitive framework for analyzing non-price effects. It is unclear how the agencies will seek to resolve concerns about a merger when, for example, price effects suggest an enforcement outcome and innovation effects suggest that the merger would be pro-competitive.
- The 2010 Guidelines' approaches to entry, efficiencies, and failing firms are largely consistent with the 1992 Guidelines. Notably, however, the two-year standard for "timely, likely, and sufficient" entry into the market to prevent the enhancement of market power by a merged firm

has been eliminated, suggesting that such entry might occur far sooner, or could occur after two years, depending upon the market. The parties will still bear a significant burden in trying to rely on any of these factors to defend a horizontal merger that the agencies view as problematic, particularly, in the case of entry, where there is no history of the type of entry upon which the merging firms might rely.

- Many comments to the April 20 draft of the 2010 Guidelines expressed concern about referencing the economic test of “upward pricing pressure,” given that it almost always predicts some price increase as a result of a horizontal merger, but does not clarify how much of a price increase should be of concern. Some commentators proposed that the agencies adopt a presumptive efficiencies “offset” of 10%, as once suggested by the DOJ and FTC’s chief economists. This offset is not referenced in the 2010 Guidelines, however, and the Guidelines otherwise do not explain how this test will be applied in practice.

As noted above, the 2010 Guidelines are not law and are not binding on the courts. In some respects, their analytical approach is in tension with legal precedent, which places much more emphasis on market definition. Nevertheless, since most horizontal merger investigations are resolved at the agency level, rather than challenged in court, the Guidelines provide important insight into how best to address agency concerns.

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