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ADVISORY

May 2010

US AGENCIES RELEASE PROPOSED REVISION TO HORIZONTAL MERGER GUIDELINES

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In an effort to provide a more accurate representation of how the US antitrust authorities evaluate the likely competitive effects of mergers involving actual or potential competitors and their legality under the antitrust laws, the Federal Trade Commission (FTC) and US Department of Justice (DOJ) recently released for public comment the Agencies' proposed revision to the Horizontal Merger Guidelines (Proposed Guidelines).[1] The current version of the Horizontal Merger Guidelines was issued initially in 1992 and last revised in 1997 (1992/1997 Guidelines).

A significant objective for the revisions was to codify the shift away from an analysis premised on market definition towards a more flexible, fact-specific inquiry that employs a variety of tools to determine the likely competitive effects of a merger. In this respect, and many others, the Proposed Guidelines do not represent a significant departure from the Agencies' current merger review practice that was also detailed in the Merger Commentary.[2] Rather, the Proposed Guidelines update the 1992/1997 Guidelines to incorporate the Agencies' learning over the past 18 years and reflect the analytical practices and enforcement policies that the FTC and DOJ currently employ. While the Proposed Guidelines provide insight into current Agency thinking on key issues, the agencies likely also hope that the revised guidelines will influence the courts, where FTC and DOJ merger challenges have seen only mixed success.

MARKET DEFINITION

One of the most significant changes in the Proposed Guidelines relates to the diminished role of market definition in merger review. Although still required, market definition is no longer the requisite starting point for merger analysis. The Agencies treat market definition as a complementary tool in the analysis of likely competitive effects of a transaction. The Proposed Guidelines suggest that market definition should be informed by more direct forms of evidence, rather than serve as "an end in itself." Proposed Guidelines § 4. Consequently, where more direct evidence of competitive effects is available, the Agencies will rely less on market definition in their analysis.[3]

1 The Proposed Guidelines are available on the FTC's webpage at: http://www.ftc.gov/os/2010/04/100420hmg.pdf.

2 The Merger Commentary is available on the FTC's webpage at: http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf.

3 Defining the relevant geographic and product market will always have some relevance in a merger analysis as it is necessary to evaluate competitive alternatives available to customers.

The Proposed Guidelines, however, update and expand the discussion of market definition, specifically focusing on the analytical tools used to define product and geographic markets. While the "hypothetical monopolist" test remains at the core of product and geographic market definition, the Proposed Guidelines suggest that the test need not result in a single relevant market or lead to evaluation of only the smallest market satisfying the test. Proposed Guidelines § 4.1.1.

As an example of one complementary tool, the Proposed Guidelines explicitly recognize that "critical loss" analysis may inform market definition. Proposed Guidelines § 4.1.3. Recognizing that a hypothetical monopolist who could sustain a price increase might decline to do so because the cost of lost business would more than offset the benefit of increased price, critical loss analysis tests whether a "small but significant non-transitory increase in price" (SSNIP) on one or more products in a candidate market would raise or lower the profits of a hypothetical monopolist. In assessing the predicted loss, the Agencies will consider evidence of customer substitution and pre-merger margins, and thus for critical loss analysis to be considered, it should be consistent with evidence. Proposed Guidelines § 4.1.3.

In defining geographic markets, the Agencies consider the locations of both customers and suppliers. When the merged firm could discriminate based on customer location, the Agencies may define geographic markets based on the locations of targeted customers without regard to where the sellers are located. Similarly, where the Agencies define geographic market based on supplier locations, all sales by suppliers in the geographic market are included regardless of the location of the customers. In considering the geographic market, the Agencies consider a range of evidence including:

- History of shifting purchases to different geographies in response to changes in price or other terms;
- Costs and difficulty of transport of the relevant product;
- The need for local service or support;
- Whether sellers base decisions on perceived ability of the customer to purchase in other geographies;
- Costs and delays of switching to suppliers in other geographies; and
- Influence of the customer's downstream competition in output markets.

MARKET SHARES AND MARKET CONCENTRATION

Under the Proposed Guidelines, market shares and market concentration will no longer operate as direct proxies for the likely competitive effects of a merger. Rather, market shares and market concentration will be just "one useful indicator of the likely competitive effects of a merger." Proposed Guidelines § 5.3. The Agencies will also give more weight where market shares historically have remained stable, especially where changes in relative prices or costs occurred.

In addition, the Agencies revised the market concentration index thresholds to increase the required level of concentration before presuming a transaction raises significant competitive concerns or presuming the transaction will likely enhance market power. The new Herfindahl-Hirschman Index (HHI) thresholds for market concentration[4] are as follows:

- Mergers involving an increase of HHI of less than 100 points are unlikely to have adverse competitive effects;
- Mergers resulting in an HHI of less than 1,500 are unlikely to have adverse competitive effects;
- Mergers that result in an HHI between 1,500 and 2,500 (defined as a moderately concentrated market) that involve an increase in HHI of 100 points or more are likely to raise significant competitive concerns;
- Mergers resulting in an HHI above 2,500 (defined as a highly concentrated market) that involve an increase

4 The HHI is calculated by summing the square of the market share of each market participant.

in HHI of 100 points to 200 points raise significant competitive concerns; and

- Mergers resulting in highly concentrated markets that involve an increase in HHI of more than 200 points are presumed to be likely to enhance market power.

Despite raising the required concentration level before finding a likelihood of adverse effects, the practical consequence of such a change are likely to be minimal because the Agencies place little weight on the HHI except when challenging a transaction in court.

UNILATERAL EFFECTS

The Proposed Guidelines include a more extensive and updated discussion of unilateral effects arising from mergers. Most significantly, the Proposed Guidelines appear to have dropped the presumption that a 35 percent combined market share implies that the merging parties' products were close substitutes. In addition, the Proposed Guidelines specifically address the use of "diversion ratios" and "merger simulation," including what is known as the "upward pricing pressure" test, which are described as tools for analyzing the level of competition between differentiated products. Proposed Guidelines § 6.1. Diversion ratios attempt to quantify the rate of substitution between merging firms' products due to price increases. Depending on available data, merger simulation attempts to quantify unilateral price effects by modeling various pricing scenarios of market participants using economic modeling. The recognition of both economic analyses further demonstrates that the Agencies are focused on competitive effects, rather than relying on structural presumptions.

COORDINATED EFFECTS

The coordinated effects section of the Proposed Guidelines has been revised to reflect that the Agencies examine market share concentrations in conjunction with other evidence of vulnerability to coordination in determining whether coordinated behavior among firms is likely post-merger. The Proposed Guidelines emphasize that the Agencies give substantial weight to past or attempted collusive behavior in relevant markets or comparable product markets regardless of whether the attempts were successful. The Proposed Guidelines also suggest that harm can result even if not all firms in the relevant market engage in coordination.

In addition, the Proposed Guidelines provide an updated list of other evidence that markets are vulnerable to collusion, including, among other things:

- Transparency of rivals' actions;
- Strong and fast response by rivals to a firm's competitive initiatives;
- Homogenous products with easy switching and little technological innovation;
- Sales made on the basis of large and long-term contracts; and
- Low elasticity of demand for the relevant product.

INCREASED SCRUTINY OF PRICE DISCRIMINATION

The Proposed Guidelines increase the prominence and detail of how the agencies address price discrimination in merger review by devoting a new section to the topic. Because merging parties potentially have the ability to direct price increases to some, but not all customer segments, the Agencies may evaluate the competitive effects (or define relevant markets) by type of customer. However, the Proposed Guidelines recognize that in order for a firm to price discriminate it must be able to: (1) effectively differentiate pricing (directly or indirectly) and (2) limit arbitrage opportunities. Proposed Guidelines § 3.

NEW SECTIONS OF THE GUIDELINES AND ADDITIONAL REVISIONS

1. ***Evidence of Adverse Competitive Effects.*** In a new section of the Guidelines, the Agencies articulate the types and sources of evidence that have widely been used in analyzing mergers. While the list is non-exhaustive, it includes the items that have been found to be "the most informative in predicting the

likely competitive effects of mergers." Proposed Guidelines § 2. The list of items includes:

- Pre-merger business decisions of the merging parties;
- Actual effects of consummated transactions;
- Natural experiments (e.g., the Agencies will look to the effects of mergers of comparable firms and/or competitive events in comparable markets);
- Comparisons of the merging firms' behavior, such as pricing decisions in markets where they do and do not compete;
- Market shares and concentration in relevant markets;
- Evidence that the merging firms are or are likely to become substantial head-to-head competitors; and
- Potential elimination of a "maverick" firm as a result of the merger.

In addition to the types of evidence, the Agencies list three of the most commonly available and reasonably reliable sources of evidence they use:

- **Merging parties**. While the Proposed Guidelines express a preference for documents created in the normal course of business rather than for the purpose of regulatory review, the Agencies will consider documents, data, and testimony that describe competitively relevant conditions or reflect actual business conduct and decisions. The Agencies will also look for any explicit or implicit evidence that the merged entity will raise prices, restrict output, delay innovation, withdraw products or reduce quality. Notably, the Proposed Guidelines also discuss that "a high purchase price" may indicate that that the intent of the transaction is to reduce competition, despite no discussion of how such a determination would be made. Proposed Guidelines § 2.2.1.
- **Customers**. Customers can provide information to the agencies on their likely responses to price increases, the impact of historical entry events, and generally may express concerns about a proposed merger. But, the Agencies will place differing weight on information from customers based on differences in market positioning as well as the ability to pass on price increases to downstream customers.
- **Other industry participants and observers**. This group includes suppliers, indirect customers, other industry participants, and industry analysts. While the Agencies suggest they do not generally rely on the overall view of rival firms, they often look to rivals for information about the merging firms or general market operations.

2. ***Power Buyers***. In a new section dedicated to powerful buyers, it appears that the Proposed Guidelines may give increased weight to an argument that powerful buyers may constrain a post-merger price increase. But, the Proposed Guidelines also suggest that the Agencies will carefully examine how the merger may affect these powerful buyers, including whether market power can be exerted against weaker buyers and whether favorable pricing terms obtained by power buyers simply reflect price discrimination. Proposed Guidelines § 8.
3. ***Monopsony Power.*** The Proposed Guidelines include enhanced treatment of mergers of competing buyers and the possibility that such a transaction would result in monopsony power. In examining mergers of competing buyers, the Agencies examine whether the merger will reduce output in the upstream market because of reduced competition to buy. The Proposed Guidelines indicate that the agencies will not require a reduction of output or higher prices in the downstream market to find a reduction of competition in the upstream market anticompetitive. Proposed Guidelines § 12.
4. ***Partial Acquisitions.*** The Proposed Guidelines include a separate section that sets forth the Agencies'

analytical framework for reviewing an acquisition of a minority position of a competing firm. The Agencies indicate they will employ a similar flexible, fact-specific inquiry focusing primarily on three principal factors:

- The ability to influence the competitive conduct of the firm;
- Reductions in incentives for the acquiring firm to compete; and
- Access to non-public competitively sensitive information from the target firm.

5. ***Market Participants.*** The Proposed Guidelines provide a clearer articulation of which firms the agencies include as market participants. In addition to those firms that already derive revenue in the relevant market, market participants also include committed entrants and firms that can easily reposition or provide a rapid supply response with a direct competitive impact in the event of a SSNIP. Proposed Guidelines § 5.1.
6. ***Entry.*** The Proposed Guidelines maintain that only timely, likely, and sufficient entry can counteract the anticompetitive effects of a merger. However, the revision removes both the specific time frames and the minimum viable scale methodology from the 1992/1997 Guidelines. *See* 1992/1997 Guidelines §§ 3.2 and 3.3. According to the Proposed Guidelines the Agencies give substantial weight to evidence that shows a history of entry into the relevant market and that suggest entry is likely to be of scale and strength similar to that of one of the merging firms.
7. ***Efficiencies.*** The most significant revision to the efficiencies section is an indication that the Agencies may credit efficiencies that lead to new or improved products. In addition, the Agencies suggest that they are most likely to credit efficiencies substantiated by analogous past experiences. Proposed Guidelines § 10.
8. ***Failing Firms.*** The Agencies will continue to credit claims that the merged assets would otherwise exit the relevant market where (1) the firm is unable to meet its financial obligations in the near future; (2) the firm is unable to reorganize successfully under the bankruptcy laws; and (3) there is no reasonable alternative buyer who does not pose a similar competitive threat. Proposed Guidelines § 11.

ADDITIONAL CONSIDERATIONS

1. ***Consummated Mergers.*** The explicit discussion of consummated mergers confirms a recent trend in Agency challenges to such transactions. As one would expect, the Agencies will consider evidence of the actual effects of the merger, such as post-transaction price increases or other adverse consumer effects. But, according to the Proposed Guidelines, the Agencies will treat consummated mergers prospectively and find a transaction anticompetitive "even if such effects have not yet been observed" because the merged entity may moderate conduct because of the possibility of a post-merger review. Proposed Guidelines § 2.1.1. While consummated mergers have always been subject to review, such a statement seems to raise the possibility that the Agencies may challenge more consummated mergers.
2. ***Increased Relevance of Profit Margins and Marginal Costs.*** References to profit margins, profitability, and marginal costs, are found throughout the Proposed Guidelines, suggesting that they are tools the Agencies are employing as proxies for market power and competitive effects. A few examples include:
   - In its discussion on sources of evidence, the Proposed Guidelines suggest that where prices are set well above marginal cost, the firm is either engaged in collusion or its customers are not highly sensitive to price. Proposed Guidelines § 2.2.1.
   - In discussing the likely unilateral competitive effects of a merger where auctions or bargaining are typical, the Proposed Guidelines indicate that the adverse competitive effects of a merger tend be greater where the pre-merger winning bids were more profitable. Proposed Guidelines § 6.2.

- In discussing the hypothetical monopolist test, the Proposed Guidelines suggest that high pre-merger margins typically indicate that each firm's product is not highly sensitive to price. Proposed Guidelines § 4.1.3.

This focus on margins and marginal costs, without qualification, may prove problematic for merging firms in industries characterized by high fixed and low marginal costs (e.g., pharmaceutical and technology industries).

3. ***Non-Price Effects.*** The Proposed Guidelines also appear to emphasize the importance of the potential for non-price effects post-transaction. For instance, the Proposed Guidelines suggest that a merger may result in diminished competition through reduced innovation related to existing or new products, as well as the possibility that the merged firm will cease offering one of the relevant products post-transaction. Proposed Guidelines § 6.4. While the Proposed Guidelines are clear that consolidation of products is efficient where variety is of little value to consumers, the Agencies examine carefully both the price and non-price effects of transactions.[5]

CONCLUSION

While the Proposed Guidelines provide a more accurate representation of the current analysis employed by the DOJ and FTC in merger reviews, courts have continually relied on the 1992/1997 Guidelines analytical framework, which is based in large part on market definition. This approach is consistent with the text of Section 7 (which refers to a substantial lessening of competition in a "line of commerce") and with Supreme Court precedent (which holds that "[d]etermination of a relevant market is the necessary predicate" to a Section 7 case).[6] Because the agencies have faced trouble on market definition issues in court (including in the challenge of the Oracle/Peoplesoft merger,[7] where the government's case was rejected because the judge concluded that the government had not proven a relevant product market), the Proposed Guidelines are also likely an attempt to influence the way the courts interpret and apply the antitrust laws in horizontal merger cases. As current agency practice becomes codified in a new set of Horizontal Merger Guidelines, the impact of these revisions may best be evaluated both according to how the Agencies shape their merger challenges and the analytical framework employed by courts in deciding post-revision cases. Moreover, given the Agencies' increased focus on margin evidence and non-price effects, as well as using purchase price to infer evidence of intent, it will be interesting to see the public comments and whether the Agencies will revise the Proposed Guidelines.

5 *See In re Intel Corp.*, FTC Docket No. 9341, Concurring and Dissenting Statement of Commissioner Rosch (Dec. 16, 2009) ("[A]lthough Intel's alleged conduct led to higher prices in the CPU markets, that alleged conduct can still be within the Commission's Section 5 powers even if Intel cannot be said to have caused price increases.").

6 *United States* v. *E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 593 (1957).

7 *See United States* v. *Oracle Corp.*, 331 F.Supp. 2d 1098, 1123-48 (N.D. Cal 2004).

On May 10, 2010 the firm hosted a webinar to discuss the draft Guidelines led by Bill Baer and Debbie Feinstein of Arnold & Porter and Professor Dennis Carlton of Lexecon and University of Chicago. An archived copy of the webinar and a downloadable podcast are available at http://www.arnoldporter.com/events.cfm?u=TheProposedRevisionstotheHorizontalMergerGuidelinesWhatFirmsContemplatingaTransactionShouldKnow&action=view&id=607.

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