Competition Law360 (Also ran in Corporate Law360)
June 28, 2010

8 Considerations For Your Next Information Request

--By Kelly Smith, Arnold & Porter LLP

Law360, New York (June 28, 2010) -- On April 20, 2010, the Federal Trade Commission and the U.S. Department of Justice ("the agencies") released a proposed set of revised horizontal merger guidelines ("Proposed Guidelines"). The extended comment period ended on June 4, 2010. The final guidelines are expected sometime this fall and are likely to look substantially similar to the proposed guidelines.

Little in the proposed guidelines is totally new or unexpected. Indeed, most changes reflect the evolution of the agencies' practices since the last revision. The most significant development is the transition from a five-step process to a flexible, multifaceted approach.

The proposed guidelines also reflect a substantial increase in the variety and sophistication of empirical economic tools available to the agencies. As the agencies have evolved their analytical tool kit, so have the firms, attorneys and economists advocating before them. The proposed guidelines articulate the data and analyses the agencies rely upon.

This article provides similar guidance for antitrust counsel, serving as something of a shopping list to guide the first few exchanges of information with clients to prepare antitrust counsel to anticipate, address and defend a horizontal deal before the agencies today.

1) Market Definition (Still) Matters

Much has been said about the de-emphasized role of market definition in the proposed guidelines, which say that analysis need not start with market definition and in some cases may not rely on it at all. A de-emphasized role, however, does not mean that market definition should receive any less attention. This is true for three reasons.

First, market definition is still featured in the proposed guidelines. The agencies haven't changed tools; they have simply added more. Second, evaluating market definition starts with asking the client about their products' substitutes and complements — data that factor into almost all merger analyses, including the new ones. Third, while the agencies have evolved their approach over the years, they have met with resistance in the courts.

The agencies' struggles in Oracle/PeopleSoft and Whole Foods/Wild Oats are prime examples of the supremacy of market definition in the courts. Unless and until we see the proposed guidelines have some effect evolving the courts' comfort with new analytical tools, market definition will play a starring role.

2) But, There is More than One Way to Define a Market

Nonetheless, in line with the increasing sophistication of the agencies' economic tools, market definition is more complex today. In practice, this means antitrust advocacy neither starts with nor stays confined by a single relevant market. The proposed guidelines make clear that "relevant markets need not have precise metes and bounds."

Each product a client sells may have its own relevant market, which may overlap in analytically challenging ways. What does this mean in practice? The starting point for thinking about a merger is getting a very good sense of what products the client sells and what substitutes exist for each product.

The agencies may also divide relevant markets into narrow subsets. Narrowing is especially likely in cases of potential price discrimination, and the impact can be significant. In fact, the proposed guidelines recognize that when "prices are negotiated individually with customers, the hypothetical monopolist test may suggest relevant markets that are as narrow as individual customers."

To anticipate a narrowed relevant market analysis based on price discrimination, counsel should look to see if both necessary conditions for price discrimination are satisfied. First, the seller must have some way of matching high price products with high willingness to pay customers. Accordingly, it is important to ask clients how their customers are different and whether products are sold in different ways at different prices. Second, price discrimination cannot be sustained in the presence of arbitrage.

3) Take Shortcuts

Adverse competitive effects include higher prices, restricted output, and reduced innovation and variety. Concentration is not itself an adverse competitive effect, but is at best a predictive proxy. One of the most important developments in the proposed guidelines is a direct approach to the primary question of merger review — Is the merger likely substantially to lessen competition? This direct approach is most apparent in the section on unilateral effects.

In 2006, the agencies issued the commentary on the Horizontal Merger Guidelines explicitly recognizing that concentration has little to do with whether adverse competitive effects are likely in the aftermath of a merger. In practice, this means that thinking about the potential unilateral effects of a merger starts with prices, margins, and substitution. Number and concentration of competitors are at best secondary.

4) Differentiate Differentiated Products

Unilateral effects, especially with respect to differentiated products, may be the area of horizontal merger analysis that has undergone the most change in the last two decades.

Much of this development has been the academic focus of the two Berkeley economists who now serve as the chief economists for the DOJ Antitrust Division and the FTC: Carl Shapiro and Joseph Farrell, respectively. Their academic work on upward pricing pressure ("UPP") and critical loss analysis ("CLA"), and its incorporation into the proposed guidelines suggests that the agencies will be looking closely at differentiated products and applying relatively unfamiliar analytical tools in the process.

In practice, this means two things. First, antitrust practitioners are becoming increasingly familiar with a new set of relatively complex economic models. Second, issue-spotting potential differentiated product problems is an important component of an overall horizontal merger analysis.

Spotting these problems starts with being able to identify differentiated products, which are non-homogenous products that are substitutes for one another. The concern with a merger between sellers of differentiated products is that the merged firm may be more likely to raise prices unilaterally because sales that would have been lost as a result of the price increase are recaptured. The merged firm's ability/incentive increases with the degree of substitution between the products and the margin earned on additional sales of each.

5) Know Your Diversion Ratios

The first step in assessing how problematic unilateral effects for differentiated products may be starts with calculating the degree of substitution between products (i.e., cross-price elasticity of demand). The agencies propose to measure this with a diversion ratio, which, according to the proposed guidelines, equals "the fraction of unit sales lost by the first product due to an increase in its price that would be diverted to the second product."

Note, however, that diversion ratios are not the sort of data kept on hand by most companies. When evaluating unilateral effects, the agencies are likely to ask for data that will allow them to construct diversion ratio estimates, such as win/loss reports, customer surveys about product preferences, and data reflecting customer switching patterns.

The proposed guidelines devote an entire section to the usefulness of auction and bidding data in merger analysis, which when available are highly likely to drive diversion ratio analysis. Counsel (and their economists) can use the same data to anticipate and defend against concerns related to high diversion ratios.

6) Four Weaknesses of UPP

Upward pricing pressure is the next step of evaluating potential unilateral effects in mergers involving differentiated products. Farrell and Shapiro developed the test as an alternative to market definition plus HHI concentration.

Without explicitly calling it "upward pricing pressure" the proposed guidelines explain the approach in simple terms as the incentive "the merger gives the merged entity ... to raise the price of a product previously sold by one merging firm and thereby divert sales to products previously sold by the other merging firm, boosting profits on the latter products. ... [T]hat boost to profits is equal to the value to the merged firm of sales diverted to those products." The number of sales diverted is estimated using the diversion ratio, and the value of those sales is calculating by multiplying by the difference between price and marginal cost.

As is clear from the definition, it is important to have a good handle on diversion ratios because they feed directly into UPP calculations. It is also important to have a good sense of UPP's other points of flexibility, which are profit margins, cost pass-through and efficiency offsets. More specifically, challenging a finding of positive UPP can take four forms.

First, argue that the diversion ratio estimate is too high. Second, argue that the profit margins applied to the diversion ratio are too large. Third, argue that the costs that the merging firms pass through to customers are lower than estimated (implying a lower profit margin). Fourth, argue that the deal will produce more efficiencies than the agencies credit, thereby reducing the merged firm's marginal costs by more than estimated, further offsetting UPP.

7) CLA is the New HMT

Diversion ratios also play an important role in critical loss analysis. The proposed guidelines set up CLA as a more sophisticated form of the traditional hypothetical monopolist test ("HMT"). CLA recognizes that a price increase produces both a benefit — buyers pay more — and a cost — fewer buyers buy. At some point, the price increase will be so high that the cost exceeds the benefit.

If the hypothetical monopolist imposing an SSNIP (approximately 5 percent) expects to make profits above zero, then critical loss analysis suggests that the hypothetical monopolist would and could sustain an SSNIP. As the proposed guidelines explain, agencies may use CLA when the data are available to do so. These data are the same as those that feed into diversion ratio calculations, namely anything that predicts the amount of substitution between products resulting from a price increase. As discussed below, profit margins are also an important element of CLA.

8) Margins Need Attention

Margins and marginal costs frequently factor into the proposed guidelines' analytical tools. For example, high profit margins increase UPP. High margins also make a SSNIP more likely to pass the critical loss threshold, which would result in a narrower relevant market definition.

Moreover, the proposed guidelines explicitly say that "high pre-merger margins normally indicate that each firm's product individually faces demand that is not highly sensitive to price." Yet actual economic marginal cost and marginal profit can be near impossible to estimate accurately. Usually the agencies make do with accounting costs found in firms' financial statements, which estimate variable costs rather than marginal costs.

Thus, understanding the inputs to firms' variable cost estimates, and the time periods over which they are calculated can assist antitrust counsel in preparing to address and challenge the proposed guidelines' many tools and assumptions that rely on accurate estimates of marginal cost.

--By Kelly Smith, Arnold & Porter LLP

Kelly Smith is an associate in Arnold & Porter's Washington, D.C., office. She is admitted only in California; practicing law in the District of Columbia pending approval of application for admission to the D.C. Bar and under the supervision of lawyers of the firm who are members in good standing of the D.C. Bar.