TEN WAYS TO RETHINK YOUR NEXT CLIENT INFORMATION REQUEST: PRACTICING UNDER THE 2010 HORIZONTAL MERGER GUIDELINES

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Merger counseling begins with questions. A thorough understanding of the deal, products, and competitive landscape is the essential first step to assessing antitrust risk and advocating on behalf of merging parties. Of course, the information gathering process is shaped by the Agencies' analytical approach to merger review. As their review process continues to evolve, so too should the questions counselors ask and the information they elicit from their clients during early interactions. The release of the *Horizontal Merger Guidelines* by the FTC and DOJ this past August ("*Revised Guidelines*")[2] presents an opportunity for reevaluating and recalibrating the approach to these early conversations.

There is little that is totally new or unexpected in the *Revised Guidelines*. FTC Chairman Jon Leibowitz explained, "[e]ighteen years have passed since the Horizontal Merger Guidelines were revised. During that time the agencies' approach has evolved significantly . . . . The proposed Guidelines . . . reflect the current state of merger analysis at the FTC and DOJ, and will help make the process more transparent to American businesses and courts."[3] The most significant development since the Horizontal Merger Guidelines were last revised is a move away from a five-step process that began with market definition and moved sequentially through efficiencies and, when applicable, failing firm defenses. Instead, the *Revised Guidelines* describe a "flexible and integrated

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[2] U.S. DEP'T OF JUSTICE AND FEDERAL TRADE COMM'N, HORIZONTAL MERGER GUIDELINES (Aug. 19, 2010), available at ***http://ftc.gov/os/2010/08/100819hmg.pdf*** [hereinafter REVISED GUIDELINES].

[3] Press Release, Fed. Trade Comm'n, Federal Trade Commission Seeks Views on Proposed Update of the Horizontal Merger Guidelines (Apr. 20, 2010), *available at* http://www.ftc.gov/opa/2010/04/hmg.shtm.

approach to evaluating competitive effects, using whatever evidence and methodologies are informative."[4]

The *Revised Guidelines* not only memorialize the evolution toward a multi-faceted evaluative approach, but also increase the variety and sophistication of the empirical economic tools available. The information antitrust lawyers and economists seek from their clients should likewise evolve. This article suggests areas for questions and information requests that will prepare counselors for interactions with Agency staff. The hope is that it serves as something of a check list to guide the first few exchanges of information with clients in order to prepare antitrust counsel to anticipate and address issues while defending horizontal deals before the Agencies today.

1. Market Definition (Still) Matters

Much has been said about the deemphasized role of market definition in the *Revised Guidelines*. It is true that measurement of market shares and market concentration, what appeared to be an essential first step in the 1992/1997 Guidelines, is described in the *Revised Guidelines* as "not an end in itself"[5] but merely one of the tools the Agencies outline. Not only is it the case today that "the Agencies' analysis need not start with market definition," but it is also true that some analytical tools identified in the *Revised Guidelines* do not rely on market definition at all.[6]

The de-emphasis of market definition in the *Revised Guidelines*, however, does not mean that market definition should receive any less attention in an initial merger evaluation. This is true for three reasons. First, market definition is still featured in the *Revised Guidelines*. The Agencies haven't changed tools, they

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[4] Carl Shapiro, Deputy Assistant Attorney General, Antitrust Division, U.S. Dep't of Justice, Updating the Merger Guidelines: Issues for Upcoming Workshops at Fall Forum: ABA Antitrust Section §3 (Nov. 12, 2009).

[5] REVISED GUIDELINES, *supra* note 2, at §4.

[6] *Id.*

have simply added more. Second, evaluating market definition starts with asking the client about their products' substitutes and complements – data which are pertinent to almost all of the analytical tools the *Revised Guidelines* use, including the new ones. As the *Revised Guidelines* note, even when the Agencies skip market definition, "evaluation of competitive alternatives available to customers is always necessary at some point in the analysis."[7] Third, courts that decide agency challenges to mergers continue to focus on market definition,[8] so gathering information about market definition allows counselors to evaluate the likely outcome of litigation.

While the Agencies have evolved their approach over the years, they have met with resistance in the courts when they stray from traditional market definition analysis. The Agencies' struggles in *Oracle/PeopleSoft* and *Whole Foods/Wild Oats* are prime examples.[9] In both instances, a district court sided with defendants and in doing so applied a traditional relevant market analysis. Litigation – even the successful defense of an agency challenge – is rarely the favored outcome of merging parties at the outset of an Agency investigation. Nevertheless, the theories an Agency raises during early stages of the investigation, and the likelihood that the Agency will decide to challenge a transaction, are affected by the likely outcome if the merger were litigated. Unless and until we see that the *Revised Guidelines* have some effect evolving the courts' comfort with new analytical tools, market definition will continue to share the stage, if not play a starring role.

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[7] REVISED GUIDELINES, *supra* note 2, at §4.

[8] The Supreme Court's holding in *United States v. Philadelphia National Bank* still controls today. 374 U.S. 321, 363 (1963) (relying on relevant market analysis as standard for evaluating competitive effects).

[9] United States v. Oracle Corp., 331 F. Supp. 2d 1098 (N.D. Cal. 2004); Fed. Trade Comm'n v. Whole Foods Mkt., 502 F. Supp. 2d 1(D.D.C. 2007) *rev'd* 533 F. 3d 869 (D.C. Cir. 2008).

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

Nonetheless, in line with the increasing nuance and sophistication of the economic analyses available to the Agencies, the analysis of market definition under the *Revised Guidelines* has become more complicated. In practice, this means that counsel shouldn't expect that antitrust advocacy will start and stay confined by a single relevant market. "[R]elevant markets need not have precise meets and bounds"[10] and "[t]he hypothetical monopolist test ensures that markets are not defined too narrowly, but it does not lead to a single relevant market."[11] As Carl Shapiro, chief economist for the DOJ Antitrust division, explained: "relevant antitrust markets identified using the hypothetical monopolist test do not neatly partition products into various markets . . . . [T]he test generates one relevant market starting from each product sold by the merging firms, and these markets need not be the same: they can overlap, they can be nested, or they can be disjoint."[12]

What does this complex view of market definition mean for the early stages of merger counseling? The starting point for thinking about a merger is getting a very good sense of what products the client sells, how and where the products are sold, and the ways in which customers think about the products and their substitutes. As important as seeking an answer to these questions, is asking the questions in a way that uncovers variations in the responses: Are customer preferences homogenous or do customers differ in terms of purchasing patterns and price sensitivity? What is the set of substitutes that customers perceive are available to them and how does willingness to substitute vary? Are there differences in how the product is consumed based on geography? Have there been any changes in how the product has been consumed over time? Have those

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[10] REVISED GUIDELINES, *supra* note 2, at §4.

[11] REVISED GUIDELINES, *supra* note 2, at §4.1.1.

[12] Carl Shapiro, Deputy Assistant Attorney General, Antitrust Division, U.S. Dep't of Justice, Updating the Merger Guidelines: Issues for Upcoming Workshops at Fall Forum: ABA Antitrust Section §5.A (Nov. 12, 2009).

changes applied uniformly across all customers, or have certain customer segments or geographies been more affected than others? Such questions can help identify the relevant markets and narrower subsets of those markets that may be of interest to the Agencies.

3. Price Discrimination Has Prerequisites

Another way to think about narrowed customer segments is from a price discrimination perspective. As the guidelines explain, "If a hypothetical monopolist could profitably target a subset of customers for price increases, the Agencies may identify relevant markets around those targeted customers . . . . Markets to serve targeted customers are also known as price discrimination markets."[13] While "the Agencies often define markets for groups of targeted customers," when "prices are negotiated individually with customers, the hypothetical monopolist test may suggest relevant markets that are as narrow as individual customers."[14]

In order to narrow the relevant market based on price discrimination, the Agency must also be able to support a theory that price discrimination is viable. Before defining a market based on the existence of price discrimination, the Agency should be able to prove that both necessary conditions exist:

- First, the seller must have some way of pricing differentially. This creates an opportunity for antitrust counsel to challenge an Agency's narrow market view on the grounds that one or both prerequisites for price discrimination are not satisfied. This means that the seller must be able to identify who will pay more and match high price products with the high willingness to pay customers.[15] To explore whether differential pricing is possible, it

[13] REVISED GUIDELINES, *supra* note 2, at §4.1.4.

[14] *Id.*

[15] REVISED GUIDELINES, *supra* note 2, at §3.

is important to ask clients how their customers differ and whether they can sell their products so as to take advantage of different levels of price sensitivity among them.

- Second, "targeted customers must not be able to defeat the price increase of concern by arbitrage."[16] In simpler terms, the seller must be able to sell the same product at a higher price to a subset of customers, and those customers who buy at a lower price will not be able to defeat the strategy by offering for resale their low-priced goods to the high price-paying customers.

Questions focused on learning whether these conditions are satisfied promote learning both about how the Agencies may seek to use the possibility or fact of price discrimination to propose narrow markets, and the ways such an approach may best be challenged.

4. Take Shortcuts

As much as relevant market analysis remains integral, one of the most important developments reflected in the *Revised Guidelines* is a more direct approach to "the key question that the Agencies must answer: Is the merger under review likely substantially to lessen competition?"[17] Adverse competitive effects include higher prices, lower output, and reduced innovation and variety. Concentration is not itself an adverse competitive effect, but is at best a predictive proxy based on a presumption that concentrated markets are less likely to benefit consumers. Since the Guidelines were last revised in 1997, economists have developed analyses that skip the market definition step and go directly to price effects. The *Revised Guidelines* reflect that some of these more direct approaches have made their way into the Agencies' tool kit.

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[16] *Id.*

[17] DEP'T OF JUSTICE AND FED. TRADE COMM'N, COMMENTARY ON THE HORIZONTAL MERGER GUIDELINES 2 (Mar. 2006), *available at* http://www.justice.gov/atr/public/guidelines/215247.htm.

The *Revised Guidelines*' section on unilateral effects is where this movement is most apparent. This change was first articulated in the Agencies' 2006 Commentary on the Horizontal Merger Guidelines, which posit that "market concentration may be unimportant under a unilateral effects theory of competitive harm." [18] According to the Commentary, "[T]he question in a unilateral effects analysis is whether the merged firm likely would exercise market power absent any coordinated response from rival market incumbents. The concentration of the remainder of the market often has little impact on the answer to that question."[19] In practice, this means that thinking about the potential unilateral effects of a merger starts with understanding pricing practices, particularly how pricing practices vary based on the presence or absence of specific competitors.

5. Good Questions Uncover Natural Experiments

As the *Revised Guidelines* emphasize, natural experiments are a useful tool for identifying and testing potential competitive effects of a horizontal merger.[20] A natural experiment allows comparison of outcomes where there has been a random source of variation in the inputs. To uncover a natural experiment, it is helpful to ask questions about the history of the industry and to identify points of change. Examples from the guidelines include events such as "recent mergers, entry, expansion, or exit in the relevant market."[21] Inquiring about product repositioning, changes in pricing methodology, or geographic variation in product offerings may uncover other useful natural experiments.

While it is difficult to find a purely random source of variation, the less correlated the cause of variation is with the outcome of interest, the more useful the experiment will be for predicting future outcomes. For example, it can be useful to compare geographies in which the merging parties both compete to those

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[18] *Id.* at 16.

[19] *Id.*

[20] REVISED GUIDELINES, *supra* note 2, at §2.1.2.

[21] *Id.*

in which only one competes.[22] If prices are essentially the same in both markets, then, all other things being equal, it might be reasonable to infer that elimination of one competitor in those markets would not impede competition. Alternatively, the scenario is consistent with a theory that the geographies are competitively dissimilar and those areas in which both compete would have higher prices if the competitors merged. The best way to disprove the former explanation would be to show that the presence of both competitors in certain regions is unrelated to the competitive environment in that area.

6. Differentiate Differentiated Products

"In a significant proportion of merger investigations, the Agencies pursue a unilateral effects theory of harm. This proportion is especially high in cases involving highly differentiated products."[23] Unilateral effects with respect to differentiated products receive substantial attention in the *Revised Guidelines*, and also have been the academic focus of 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 the inclusion of both analytical tools in the *Revised Guidelines* suggests that the Agencies will be looking closely at differentiated products and analyzing competition between differentiated products -- and apply relatively unfamiliar analytical tools in the process.

In practice, this means two things. First, antitrust practitioners will continue to develop familiarity with these relatively complex economic models. Second, issue-spotting potential differentiated product problems will be an increasingly important part of horizontal merger analysis. Spotting these problems starts with recognizing differentiated products -- non-homogenous

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[22] *See **FTC v. Staples***, 970 F. Supp 1066 (D.D.C. 1997).

[23] Carl Shapiro, Deputy Assistant Attorney General, Antitrust Division, U.S. Dep't of Justice, Updating the Merger Guidelines: Issues for Upcoming Workshops at Fall Forum: ABA Antitrust Section §7 (Nov. 12, 2009).

products that customers treat as substitutes for one another -- and evaluating the degree of consumer substitution. Useful questions to ask clients focus on identifying the range of products in the market space and understanding how consumers view these products relative to each other. Are there preferred or premium products? How willing are customers to switch between products perceived to be at different points along the continuum between lowest price and highest quality, and has customer switching been driven by changes in pricing? If there is variation in perceived product quality, how much of it is related to actual characteristics of the product and how much is a function of marketing? Questions such as these are helpful to understanding the competitive landscape and inform the development of unilateral effects analyses such as UPP and CLA.

7. Know Your Diversion Ratios

As discussed above, understanding unilateral effects in mergers involving differentiated products is central to horizontal merger analysis under the *Revised Guidelines*. The first step in assessing how problematic unilateral effects may be starts with calculating how much substitution there is between the differentiated products the merging parties make. In economic terms, the cross-price elasticity of demand between merging firms' products is critical because the ability to raise price on one product increases with the amount of diverted sales captured by the second. The Agencies propose to measure the predicted magnitude of this post-merger effect by using diversion ratios.[24] The Agencies care most about diversion ratios between products sold by merging firms and less about those between products sold by merging and non-merging firms, which, according to the *Revised Guidelines*, have "at most secondary predictive value."[25] Nonetheless, diversion ratios between merging and non-merging products can provide important context for understanding the significance of the diversion ratios between merging products, including by showing that customers perceive the merging parties'

[24] *Id.*

[25] *Id.*

products to be relatively distant substitutes. Thus, the practitioner's analysis is not complete unless it includes interactions among the full array of products in the market.

Note, however, that diversion ratios may not always be readily available from clients. They are not the sort of data most companies track systematically. When evaluating unilateral effects, the Agencies are likely to ask for data that will allow them to construct diversion ratio estimates. Farrell and Shapiro's article on upward pricing pressure identifies potential sources of information that firms often keep and that the Agencies might use to estimate diversion ratios.

> Firms often track diversion ratios in the form of who they are losing business to, or who they can win business from. Customer surveys can also illuminate diversion ratios, as can information about customer switching patterns. . . . In bidding markets, the diversion ratio is the probability that Product 2 is the buyer's second choice when Product 1 wins. Agencies and courts often have access to data on how buyers ranked bidders in past bidding events, or at least which firms bid and won.[26]

Counsel (and their economists) can use the same data to anticipate and prepare a defense to concerns related to high diversion ratios.

While Farrell and Shapiro note that firms may regularly track win/loss information, that data may not be in the format, or be as complete as, the Agencies hope to obtain. Moreover, win/loss data are often reported in ways that compromise their reliability. For example, data can be created by busy salespeople who may be more interested in speed than accuracy, particularly in situations in which numerous competitors are present for a particular opportunity. In situations where salespeople are responsible for self-reporting, win/loss data may be biased by an incentive to overstate victories and downplay losses. It is

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[26] Joseph Farrell and Carl Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition*, THE B.E. J. OF THEORETICAL ECON.: Vol. 10: Iss. 1 (Polices and Perspectives), Article 9, at 18-19.

therefore important to understand the process by which win/loss information is created by the client and whether that process is likely to produce accurate information. Time spent learning about a client's win/loss data also permits practitioners to provide context to Agency staff when they request such information – as is increasingly likely given the importance of diversion ratios to the UPP analysis noted in the *Revised Guidelines*.

8. Four Weaknesses of UPP

Upward pricing pressure is the next step in evaluating the unilateral effects for differentiated products. The test was developed by Farrell and Shapiro as an alternative to market definition in mergers involving unilateral effects for differentiated products.[27] "Adverse unilateral price effects can arise when the merger gives the merged entity an incentive 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."[28] The unilateral effects of the merger are considered anticompetitive if on net the upward pricing pressure exceeds the efficiency-caused downward pricing pressure.[29]

As discussed above, 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 the other inputs to a UPP model: profit margins, cost pass through, and efficiency offsets, each of which is a source of flexibility in the analysis. Farrell and Shapiro explicitly recognize that a cursory initial assessment of UPP is subject to adjustment, which "might show that there is actually no

[27] Farrell and Shapiro, *supra* note 26, at 1.

[28] REVISED GUIDELINES, *supra* note 2, at §6.1.

[29] Farrell and Shapiro, *supra* note 26, at 2.

upward pricing pressure once the relevant variables are measured more accurately."[30]

More specifically, challenging a finding of positive upward pricing pressure can take four forms. First, counsel may argue that the information used to estimate the diversion ratio overstates the intensity of competition between the merging parties. Second, they may contend that the profit margins applied to the diversion ratio are too large. Third, they may take the position that that the merging firms pass through fewer costs to customers than assumed by the Agencies. (This is because "estimating the magnitude of the post-merger price increase . . . requires information about the rate at which cost increases are passed through into price increases," which depends on "the curvature of demand.")[31] Fourth, they may predict that the deal will produce more efficiencies than the Agencies credit, thereby reducing the merged firm's marginal costs by more than estimated, and further offsetting UPP. Making any of these arguments early in the merging parties' interactions with Agency staff depends on acquiring, understanding, and developing a fluency with data useful for quantifying diversion ratios, profit margins, cost pass through, and merger-specific efficiencies early in the merger review process. Efficiencies are a particular area where clients and their investment bankers may not have done much in the way of quantitatively rigorous analysis, but where there is substantial value in understanding the correct quantification of merger-specific efficiencies early in merger review.

9. CLA is the New HMT

An area outside of unilateral effects where diversion ratios are likely to play an important role is for critical loss analysis. As the *Revised Guidelines* reveal, CLA is a more sophisticated form of the traditional hypothetical

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[30] Farrell and Shapiro, *supra* note 26, at 27.

[31] Farrell and Shapiro, *supra* note 26, at 19 (emphasis omitted).

monopolist test ("HMT") which the Agencies may also consider "to assess the extent to which it corroborates inferences drawn from the evidence [from the HMT]."[32] Critical loss analysis tests whether a price increase is theoretically worthwhile by balancing the cost of customer substitution against the benefit of selling at a higher price.

As the *Revised Guidelines* explain, Agencies may take the CLA approach whenever data are available to do so. These data are the same as those that feed into diversion ratio calculations, namely anything that looks at the intensity of premerger competition to predict the amount of substitution between products resulting from a price increase. In particular, historical data on lost sales related to attempted price increases can be of particular use in preparing a critical loss analysis. Similarly useful are examples of relative price increases. For instance, can either of the merging parties quantify sales lost to a competitor that decreased its prices? What has been the impact of promotions by either merging party or their competitors on sales? As discussed below, profit margins are also an important element of the calculation.

10. Margins Need Attention

Margins and marginal costs frequently factor into the *Revised Guidelines*' analytical tools. For example, high profit margins make upward pricing pressure more likely and reduce predicted losses due to price increases. Moreover, the *Revised 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."[33]

Yet actual economic marginal cost and marginal profit can be nearly impossible to estimate accurately. As one comment submitted during the notice

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[32] REVISED GUIDELINES, *supra* note 2, at §4.1.3.

[33] REVISED GUIDELINES, *supra* note 2, at §4.1.3. However, the Revised Guidelines also clarify that "While margins are important for implementing the hypothetical monopolist test, high margins are not in themselves of antitrust concern." REVISED GUIDELINES, *supra* note 2, n. 6.

and comment period before the *Revised Guidelines* were finalized points out, "The inevitable sources of the margin data used in critical loss analysis, however, are the accounting costs found in the financial statements of the firms in question. Such accounting costs, at best, can be used to estimate short-run variable cost, not marginal cost."[34] Thus, understanding the inputs to firms' calculations of their average variable costs and the time periods over which they are calculated can assist antitrust counsel in preparing to address and challenge many of the tools and assumptions of the *Revised Guidelines*.

Conclusion

As the regulatory merger review process continues to evolve, so too does the practice of antitrust counsel. The *Revised Guidelines* highlight the importance of a compressive approach to early information gathering. The variety and sophistication of the tools the Agencies use rely on specific types of evidence. Early questions about pricing strategies, win/loss information, and natural experiments, among the other areas discussed above, are important initial steps in shepherding a horizontal merger through Agency review.

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[34] Submitted by Michael Baumann of Economists Incorporated and Paul Godek of Compass Lexecon regarding the revision of the Horizontal Merger Guidelines, May 4. 2010, *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00003.pdf.