Department of Justice

"REPORT FROM OFFICIAL WASHINGTON":
MERGER ENFORCEMENT AT THE DEPARTMENT OF JUSTICE

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It is a pleasure to be here today to discuss merger enforcement at the Department of Justice.

Merger enforcement and criminal antitrust enforcement are the two top priorities of the Department's Antitrust Division. Yesterday you heard Deputy Assistant Attorney General Judy Whalley address developments in criminal enforcement, and I will not attempt to improve upon her comments. I will only reiterate that the Department's commitment to aggressive investigation and prosecution of price-fixing, bid-rigging and all other variants of cartel behavior is unwavering. No matter what its guise, cartel behavior constitutes no more than fraud and theft from consumers, and we are making it harder than ever for violators to go undetected and unpunished.

We are equally committed to merger enforcement. The Department seeks to prevent anticompetitive mergers in their incipiency, while avoiding unnecessary interference with transactions that are competitively beneficial or neutral. In short, our goal is a sound and effective application of the antitrust laws that promotes competition and prevents anticompetitive conduct before its impact is felt.

How does this commitment translate into action? Since the beginning of our fiscal year in October 1989, the Department has reviewed approximately 1100 proposed mergers and several

consumated transactions. At present we have twenty-nine open investigations, twenty-four of which were opened this fiscal year. Since last October, we have filed or announced six merger challenges, and at least six proposed transactions were restructured or abandoned after the Department opened an investigation.

I mention these statistics because they appear to be a matter of great public interest. However, I do not believe that more action is necessarily better enforcement. Obviously, what is most important is the integrity of our internal analysis and the soundness of our decision-making. To that end, we are undertaking an extensive review of our merger enforcement policies and procedures. The review is not complete, but I want to update you on our progress.

Merger Enforcement Policy and Procedure

First, the Department and the FTC are working together to revise the Hart-Scott-Rodino premerger notification form. Our mutual experience with the form is that it does not adequately request the information needed to assess a proposed merger quickly and accurately. Insufficient or inadequate information at the notification stage slows down our preliminary screenings and may even result in our never seeing a critical document. To correct this problem, we are discussing additions to the reporting requirements. At the same time, we are considering

deleting or rewriting some of the requirements that we view as redundant or otherwise unnecessarily burdensome to the parties. The FTC and the Department are working on a Notice of Proposed Rulemaking that we hope to publish later this year. However, any input you can give us now based on your experience with the form would certainly be appreciated.

Both agencies are also exchanging views about our respective approaches to Second Requests. Our mutual goal is to minimize the burden on the parties while obtaining the information necessary to conduct a thorough analysis.

I am interested in ways of providing the business community and the private bar with a better understanding of the Department's decisions. We are considering formats for reporting useful information about the characteristics of proposed mergers that were subject to Second Requests but not challenged. Nonetheless, we believe that the Department's 1984 Merger Guidelines will continue to be the best source for a comprehensive understanding of our analytical approach to merger analysis. On that basis, the Deputies and I are using our speeches to provide information about enforcement decisions and the application of the Guidelines.

Our speeches also describe some of the concerns that are emerging as a result of our close look at the Department's 1984

Merger Guidelines. Bobby Willig, the Deputy Assistant Attorney General for Economics, and Paul Denis, Counselor to the Assistant Attorney General, are leading a project to identify and address recurrent issues that arise in connection with the interpretation and application of the Guidelines. The goal is to clarify merger analysis in areas where the Guidelines are ambiguous, unclear, or do not reflect new learning about mergers. While the basic analytical framework of the Guidelines is not in question, our work to date suggests that both the Department's internal analysis and the business community's understanding of our analysis may profit from some clarifications of the Guidelines' language. At present we are in the process of getting the views of our staff attorneys and economists, as well as those of the FTC. It is premature to provide the substantive details of the clarifications, but I can tell you that we are presently working on issues that have been and will be addressed in my speeches and the speeches of the Deputies.

Entry Analysis

Deputy Assistant Attorney General Judy Whalley gave a speech in early December which explained the Department's

approach to entry analysis. 1/ I fully endorse the analytical framework set forth in her speech and commend it to you. The framework is simple to state: ease of entry will rebut an inference of anticompetititve effect drawn from market concentration if, and only if, entry in reaction to a hypothesized price increase is timely, that is, if it would occur within two years; if it is sufficient to render the hypothesized price increase unprofitable; and if it is likely given the risks and sunk cost associated with entry.

Under this framework, the fact that entry could occur within two years -- the fact that it is technologically feasible to have a new plant in operation within two years -- is a necessary but not a sufficient condition. My conversations with members of the bar indicate that this message has gotten through loud and clear. Unfortunately, some have interpreted this framework as requiring proof of subjective intent to enter. That conclusion is incorrect. While subjective evidence is relevant to our objective investigation, our analysis of the "likelihood condition" is not a series of interviews to determine the state of mind of

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1/ J. Whalley, "After the Herfindahl's are Counted; Assessment of Entry and Efficiencies in Merger Enforcement by the Department of Justice", Remarks at the 29th Annual Antitrust Seminar, PLI (Dec. 1, 1989).

persons identified as likely potential entrants. Instead, it is an inquiry to collect the objective data necessary to determine whether, in response to a hypothesized price increase, the entrant's "expected profits from success[ful] [entry] justify placing at risk the sunk costs necessary for entry within two years at sufficient scale" 2/ - i.e. whether entry would be profitable. The fundamental question is not whether entry could conceivably occur, but whether it would occur because it would be profitable.

Five-Percent Test

Turning to another topic, the five-percent test has been very successful in clarifying and focusing merger analysis by the federal enforcement agencies and by the private bar. However, some misconceptions have developed that I would like to dispel.

For instance, there are some who mistakenly believe that the Department's use of a five-percent test implies a tolerance of mergers that raise prices less than five percent. This is not so; five-percent is not a tolerance level.

2/ Whalley at 17.

The five-percent test is an analytical tool employed to delineate the relevant market, to determine whether the merger is horizontal, to identify the other competitors in the market, and to assess the likelihood of entry. The Guidelines do not go any further than this, and neither does the Department. Used this way, in conjunction with the Guidelines' market concentration thresholds, the five-percent test simply provides the Department with a yardstick calibration of the possible market power effect of the transaction under review.

Let me explain. Concentration data alone are meaningless for comparison across industries if there is not a common basis for measurement. The five-percent test allows us to standardize the dimensions of product and geographic space over which concentration data are measured. It delineates as a relevant market the smallest group of products and geographical area over which a hypothetical monopolist would profitably raise prices by at least five-percent. This potential market power is the yardstick against which we measure the effect of the merger. In other words, the five-percent test calibrates the market power that is at issue. The Herfindahl-Hirschman Index and the Guidelines' other factors are tools to analyze whether a significant portion of this potential market power is likely to be created or facilitated by the merger.

Clearly, a merger that comes within an acceptable HHI safeharbor is highly unlikely to help the firms competing in the relevant market to behave like the hypothetical monopolist used to define that relevant market. Any such merger is unlikely to result in a price increase, much less one approaching five-percent. Accordingly, the Guidelines indicate that the Department is unlikely to challenge such a merger. In contrast, where entry is not easy and the other Guidelines factors do not apply, a merger that significantly raises the HHI above an acceptable threshold will be of more concern because it is likely to facilitate the exercise of a significant portion of the potential market power calibrated by the market definition. Even then, any actual price increase is likely to be well below five-percent. Furthermore, the Guidelines indicate that the Department would be likely to challenge such a merger, and that is most assuredly my policy.

While we will normally use five-percent as our yardstick standard and we will not arbitrarily deviate from this standard, there are some circumstances in which we will depart from the use of the five-percent figure. One circumstance is in market delineation where rigid adherence to the five-percent figure can fail to detect a genuine horizontal relationship between the merging firms. It is perhaps easiest to think about this problem in terms of geographic market definition, although the reasoning is equally applicable to both product

and geographic market definition. Consider a remote county with three rock quarries, one in the Southwest corner, the second located in the Southeast corner, and the third located in the Central part of the county. Each quarry is under independent ownership, and each is substitutable to varying degrees by purchasers of stone. If the Southeast and Southwest quarries were to merge, there could be a lessening of competition, yet it is possible that a rigid application of the five-percent test would falsely indicate that the transaction is not horizontal.

Assume that the Southwest quarry cannot profitably raise price by five-percent price because consumers will substitute to either the Central or the Southeast quarry. If more purchasers will switch to the Central quarry than to the Southeast quarry, perhaps because more stone is used between the Southwest and Central quarries than between the Southwest and Southeast quarries, then the Central quarry will be considered the "next best substitute" and, following the Guidelines, we will ask if a monopolist over the Southwest and Central quarries would profitably raise price five-percent. If the answer is yes, the market delineation process stops and the market will be comprised of both the Southwest and the Central quarries. Further, assume that a similar process starting with the Southeast quarry leads to a relevant market comprised of the Southeast and Central quarries.

At this point, a merger of the Southwest and the Southeast quarries would not appear to be horizontal. However, this conclusion may be no more than an artifact of the five-percent figure. There is no magic to five-percent. Should it be the case that the Southwest, Central, and Southeast quarries together constitute the relevant market under say a seven-percent test, then we would certainly be open to analyzing the merger as horizontal, while seeking confirmation from business evidence that the Southwest and Southeast quarries do compete head on for a significant amount of business. Indeed, it is plausible that when it is viewed in the context of this market, the merger of the Southwest and Southeast quarries would be seen to lead to a significant price increase.

The point here is that we will somewhat raise the five-percent figure if rigid adherence to it would miss a genuine horizontal relationship. This procedure is not arbitrarily applied, nor does it result in gerrymandered market definitions. The Guidelines procedure for adding products to the market insures against such practices. 3/

3/ See U.S. Department of Justice 1984 Merger Guidelines (hereinafter "Guidelines") § 2.11.

Another circumstance where the Department will depart somewhat from the five-percent figure is where rigid adherence to the five-percent figure masks lumpiness or gaps in the chain of substitution. For example, suppose all buyers of the parties' products would substitute away from both of them in reaction to a four and one-half percent price rise, but would grumblingly stay with one or the other at prices up to the four and one-half percent rise. Then, rigid adherence to the five-percent test might obscure the possibility that the merger would elevate prices by almost four and one-half percent. In the unusual event that we had information pointing to such circumstances, we would certainly employ a four-percent test to uncover the market power that the merger might create.

On a related point, let me note that the Department's use of a ten-percent figure in its investigations is not an indication that we have modified or abandoned the five-percent figure. Our experience has been that at first blush businessmen and women find it easier to respond to questions using the ten-percent figure. We may often ask the ten percent question, because in answering it, and appropriate follow-up questions, people reveal information that informs us about the likely response to a five-percent price increase.

Competitive Effects in Highly Concentrated Markets

On another topic, it is important to consider both coordinated and non-coordinated views of competitive effects when analyzing a merger of firms in a highly concentrated market where entry is not likely. The term "non-coordinated" refers to firms' independent decisions about price and output -- decisions that do not rely on the concurrence of rivals or on coordinated responses by rivals. In contrast, the term "coordinated" refers to such conduct as either tacit or overt collusion, price leadership, and concerted strategic retaliation -- conduct that requires the concurrence of rivals to work out profitably.

The Department considers both non-coordinated and coordinated effects, but often the parties to a merger or their counsel are prepared only to discuss collusion or other coordinated effects. For instance, parties may argue that a post-merger high level of concentration will have no anticompetitive effect where products are heterogeneous or where firms do not have access to information on their rivals' pricing behavior. While this type of argument may be accurate on the subject of coordinated effects, it is not complete in allaying our concerns about the anticompetitive effects of a merger. High levels of market concentration may result in either coordinated or non-coordinated effects, or both.

Consider, for example, a market for consulting services to Fortune 500 companies. Five firms participate in the market, two of whom propose to merge. Entry into the market is not easy, because clients will not substitute to consulting firms "outside the circle," even at a lower price. On these facts, and no more, the Department will be alert to the possibility of collusion. However, suppose that the clients' needs are quite particularized, and that the services offered by the firms are highly differentiated, with unpredictable costs. These facts may offset the risk of coordinated effects.

Profitable price increases may nevertheless result from such a merger as a consequence of independent non-coordinated behavior by the firms. Suppose many of the clients of one party to the merger found the other party to be their next favorite choice, and vice versa. Knowing this, the merged firm may correctly conclude that it can profitably raise its prices, despite losing some of its clients to rivals, because most of the competitive pressure from clients' favorite alternatives has been eliminated by the merger. 4/

4/ Further, the merged firms' decision to raise its price is likely to have a ripple effect in the market. The higher price charged by the merged firm will make its product a less desirable substitute, thus encouraging the remaining firms to raise their prices.

Now suppose further that firms compete through some bidding or "beauty contest" process where bids are costly to prepare and clients typically request bids from only three of the five firms. Given these facts, the Department's investigation is likely to center on the degree of preference that clients demonstrate toward the bidders they invite to compete. If bids are solicited based on decided preferences for certain firms in the pool of eligible bidders, and bidding is limited to a single round in which no bidder has information about its rivals' bids, a reduction in the number of attractive bidders will result in a lessening of competition.

Assume our investigation reveals that for ten years prior to the merger of firms A and B, a number of clients regularly invited proposals from firms A, B, and C, but never D or E. After the merger of firms A and B, the clients, still desiring three bidders, invite firm D or E to bid. In this situation, it seems unlikely that these clients would find either firm D or E as desirable as the firm it replaces, therefore the merged firm A-B would have more latitude to increase prices. Moreover, since the remaining preferred firm, C, knows that the number of preferred bidders has shrunk from three to two, price increases are likely not only from the merged firm A-B, but also from C. Simply put, if firms D and E were not previously invited to bid, neither is likely to be fully effective in filling the empty bidder's position left vacant by the merger

of firms A and B. Despite the fact that after the merger the number of eligible bidders remains greater than the number of actual bidders, competition is likely to be lessened by the reduction from three to two in the number of bidders preferred by a significant number of customers.

Obviously, the competitive impact indicated by the hypothetical is directly related to the degree of preference for the three firms that were historically invited to bid. If buyers do not distinguish among the eligible bidders, a substitution among the pool of actual bidders will have no injurious effect on competition. 5/

The fact is that even where the Guidelines' analysis of other factors suggests that collusion and other forms of coordinated behavior are unlikely 6/, analysis of non-coordinated effects is still important. In analyzing these effects, the Guidelines' consideration of market concentration 7/, ease of entry 8/, the ability of fringe firms

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5/ Alternatively, if bidding were a multiple round process in which bidders are fully informed about their rivals' bids, assessment of the likely competitive effect would turn on the relative incidence of bidding events in which the merging firms were the two leading bidders.

6/ Guidelines § 3.4

7/ Guidelines § 3.11.

8/ Guidelines § 3.3.

to expand 9/ and the closeness of substitutes 10/ remain highly relevant.

Merger Enforcement In A Global Economy

Finally, I wish to comment briefly on the role of merger enforcement in a global economy. There is no question that we must take measures to enhance America's ability to compete in global markets. But we must not be tempted by proposals that would tolerate a lessening of competition in American markets in order to gain a claimed competitive edge abroad. Our commitment to competition must never be sacrificed for short-term fixes -- America's long-term interest is best served by vigorous competition. This point is well stated in United States v. Ivaco, where the court rejected the argument that anticompetitive effects in the United States were offset by the creation of an enhanced competitive environment in Canada. 11/

Well-reasoned approaches to global competitiveness recognize that competition and antitrust work hand-in-hand.

9/ Guidelines § 3.43.

10/ Guidelines § 3.413.

11/ United States v. Ivaco, Inc., 704 F. Supp. 1409, 1427 (W.D.Mich. 1989).

President Bush's recent statement in support of joint production venture legislation exemplifies such an approach. The legislation supported by the President would clarify the antitrust laws by confirming that a rule of reason analysis applies to legitimate joint production ventures. The legislation would reduce antitrust uncertainty but it would not go so far as to permit anticompetitive conduct. This is the better course.

Thank you for your attention.