Practical Approaches:

An Insider's Look at the New Horizontal Merger Guidelines

by Paul T. Denis

The antitrust implications of most mergers are resolved at the enforcement agency level, not in the courts. Accordingly, firms contemplating mergers, as well as their legal and economic advisers, must be conversant with the framework of government merger policy. The Horizontal Merger Guidelines issued April 2, 1992, by the Department of Justice and the Federal Trade Commission alter the way in which those federal enforcement agencies assess mergers.[1] This article will highlight the practical effects of some of those changes.

Tell a Story

The new Guidelines are transformed—and informed—by the pervasive inclusion of an analytical road map for assessing the likely competitive effects of mergers. The new Guidelines contain a five step assessment: (1) market definition, measurement, and concentration; (2) the potential adverse competitive effects of mergers; (3) entry; (4) efficiencies; and (5) failure. The analytical road map links these five steps to the objective of merger analysis: preventing mergers that create or enhance market power or facilitate its exercise.[2]

As a practical matter, the analytical road map should alter the way the government and private parties approach merger investigations. In effect, it instructs both government enforcers and the merging firms to tell a story about why the merger will or will not have adverse effects. The story should be drawn from the specific market circumstances in which the transaction takes place and should be organized according to the framework provided by the new Guidelines. Since the government will be thinking about mergers in these terms, it makes sense for merging parties to structure their presentations to the agencies along the same lines.

The new Guidelines focus on the dynamic analysis of whether consumers or producers "likely would" take certain actions, that is, "whether the action is in the actor's economic interest."[3] In making this assessment, the new Guidelines avoid reliance on simplistic opinion polling of customers or competitors. For example, it is no longer enough simply to assert that everyone in the industry believes that entry will occur sometime in the future. Nor is it enough simply to assert that every firm on a list of most likely potential entrants says that it will not enter (in fact, the new Guidelines state that it is not necessary to create such a list).[4]

Instead, under the new Guidelines the prospect of future entry is relevant to merger analysis only to the extent that it will deter anticompetitive mergers, or deter or counteract the competitive effects of concern.[5] Thus, an entry story should analyze the economic incentives of firms to determine whether entry is apt to be timely, likely, and sufficient to achieve this result.

The new Guidelines also avoid wooden rules of general application. No longer will the government be "likely to challenge," based solely on an analysis of market concentration.[6] Nor will other aspects of the analysis be expressly limited.[7] Instead, the new Guidelines call for a reasoned analysis—a story—of what will happen as a result of a merger and why the particular market circumstances of that transaction are likely to lead to a given competitive effect.

The framework for telling the story of the transaction is provided by the five steps of the Guidelines' process, individually necessary and collectively sufficient to determine a merger's competitive implications. Antitrust merger analysis most often focuses on the first three steps—market definition, measurement and concentration; the potential adverse competitive effects of mergers; and entry. The remainder of this article will do the same.

Section 1

Assessment of market concentration remains integral to the Guidelines' analysis of mergers. Market concentration still provides a means of defining "safe harbors" separating transactions that are "unlikely to have adverse competitive consequences and ordinarily require no further analysis" from transactions that "potentially raise significant competitive concerns" or that are presumed to have adverse effects, depending on further analysis.[8] A merger is unlikely to create or enhance market power or facilitate its exercise unless post-merger concentration and the change in concentration resulting from the merger exceed the safe harbor levels of Section 1.51 of the new Guidelines.[9]

Before market concentration can be assessed, however, the market must be defined, market participants must be identified, and market shares must be assigned to those participants. The broad outline of this process remains unchanged from the 1984 Guidelines.[10]

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Market Definition. The market definition paradigm now analyzes consumer substitution decisions in response to a small but significant and nontransitory increase in price (SSNIP) lasting for "the foreseeable future."[11] This change from the 1984 Guidelines, which used a SSNIP lasting for one year, was made to provide a more realistic description of the decision facing consumers. If faced with a SSNIP, consumers recognize that they will be forced to pay the higher price for the foreseeable future unless they substitute some other product. No consumer is thinking that the price rise will last only one year.

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Significant practical consequences should follow from this revision to the Guidelines' treatment of market definition. The questions asked to obtain information relevant to market definition issues will change, as will the type of evidence collected. The length of the "foreseeable future" will depend on the nature of the industry. For example, in industries where technological change is rapid or there are relatively frequent product cycles, the foreseeable future may be quite short. In other, more stable industries, the foreseeable future may be relatively long.

One important change from the 1984 Guidelines' discussion of evidence relevant to market definition is that now each evidence point is to be evaluated against the objective standard of what would likely happen if a hypothetical profit-maximizing monopolist would impose at least a SSNIP. For example, buyer and seller perceptions about "substitutes" are replaced with an evaluation of buyers' and sellers' actual behavior in response to relative changes in prices or other competitive variables.[12] It is not the opinions of buyers and sellers that matter, but rather their experience with relative changes in prices or other competitive variables comparable to a SSNIP.

The new Guidelines recognize that in all attempts to define a market, consideration must be given to the timing and costs of switching from one product to another. Switching costs are important in determining whether enough consumers would find it in their economic interest to forgo purchase of the relevant product so that the reduction of sales would make a SSNIP unprofitable for a hypothetical monopolist.[13] As consumer switching can be accomplished more quickly and at lower cost, it is more likely that consumers will find it in their economic interests to switch products in response to a SSNIP.

Market Measurement. The identification of market participants and the assignment of market shares together comprise the market measurement phase of the analysis. In the Guidelines' revised treatment of market participants,[14] both the treatment of current producers or sellers and the treatment of supply responses have been changed. Understanding the changes may make the difference between correctly or incorrectly concluding that a transaction falls within the safe harbor concentration ranges.

The 1984 Guidelines generally included in the relevant market all current producers and sellers of the relevant product, with two exceptions. First, the 1984 Guidelines only included captive production of the relevant product by vertically integrated firms that consumed the relevant product in downstream processes *if* they would respond to a SSNIP by selling into the merchant market, or by expanding downstream production that used the relevant product.[15] Second, if used durable goods were included in the relevant market, recyclers and reconditioners of those goods were included in the market.

The 1984 Guidelines also included in the market production substitutors—firms with existing productive and distributive facilities, which, without significant alteration of those facilities, "could easily and economically be used to produce and sell the relevant product within one year in response to a [SSNIP]."[16] In practice, this test was construed somewhat more broadly to include any supply response that would shift existing productive and distributive facilities into production of the relevant product within one year, regardless of the significance of the alterations required.

The new Guidelines take a more realistic view of market participants. All current producers or sellers of the relevant product are treated as participants, including vertically integrated firms with captive production "to the extent that such inclusion accurately reflects their competitive significance."[17] The new Guidelines no longer require that vertically integrated firms change their behavior in response to a SSNIP in order to be counted as market participants. Vertically integrated firms are as important to the pre- and post-merger competitive interaction as firms selling into the merchant market and should be given equal weight in identifying market participants. If any portion of productive capacity, captive or not, were withdrawn from production without a change in demand for the relevant product, the price of the relevant product would rise.

Under the new Guidelines, if used durable goods are included in the relevant product market, producers or sellers of those goods also are identified as market participants. Recyclers or reconditioners, however, are no longer identified as market participants. The rationale for this is that producers or sellers of used durable goods also are likely to hold the idle stock of used durable goods, and it is this idle stock, not the existence of recyclers or reconditioners, that constrain a durable goods monopolist.[18]

Firms not currently producing the relevant product also are identified as market participants if, in response to a SSNIP, they likely would commence production of the relevant product within one year and do so without the expenditure of significant sunk costs of entry and exit. The new Guidelines refer to these firms as "uncommitted entrants" because their ability to enter and exit a market without significant investment relieves them from commitment to the relevant market.

Supply responses that would require the firm to incur significant sunk costs of entry and exit are treated as committed entry because such supply responses cannot readily be reversed without loss of the sunk investments. Committed entry is treated in Section 3 of the new Guidelines.

Although the one year time requirement for beginning production is consistent with the 1984 Guidelines, the focus on the sunk costs associated with a supply response is new. Proper identification of market participants will require an understanding of the concept of sunk costs.

Sunk costs are defined in the new Guidelines as "the acquisition costs of tangible and intangible assets that cannot be recovered through the redeployment of these assets outside the relevant market."[19] The concept of sunk cost is market specific. The costs must be uniquely incurred to supply the relevant product *and* geographic market.

There are a number of ways to assess whether a particular cost is sunk. In the case of a tangible asset, one way of determining whether an acquisition cost is sunk is to ask whether it could be resold in a used goods market or otherwise used outside the relevant market. If the asset can be sold to firms in other product or geographic markets, and it has equal value in the other market, its acquisition cost is not sunk. But if the other market is a lower valued use, the difference in value between the two uses would be considered a sunk cost.[20]

Even absent a used goods market, if the asset has an equally valued use in producing some product not included in the relevant market, its cost is not sunk. Again, if the alternative use is a lower valued use, the difference in value between the two uses would be considered a sunk cost. Similarly, in the case of intangible assets, such as research and development, sunk costs often can be determined by inquiring into the prospects for transfer of the fruits of the R&D efforts to applications in other relevant markets.

A significant sunk cost is defined as "one which would not be recouped within one year of the commencement of the supply response, assuming a [SSNIP]."[21] If, for example, the SSNIP is five percent and the market is performing competitively, a significant sunk cost is one that exceeds five percent of total annual revenues or total annual costs. (In a competitive market, total revenue equals total annual costs.) Thus, a five percent price increase would allow recoupment of sunk costs of up to five percent of total revenue over the course of a year.

The new Guidelines consider three types of uncommitted entry: production substitution, production extension, and obtaining new assets for production or sale of the relevant product. Each should be considered in properly identifying market participants.

The new Guidelines focus on the dynamic analysis of whether consumers or producers "likely would" take certain actions, that is, "whether the action is in the actor's economic interest."

Production substitution is the familiar concept of switching to production of the relevant product facilities that are currently devoted to another market. In the new Guidelines, the switch must not entail significant sunk costs of entry and exit. This is a change from the 1984 Guidelines' concept, in which the switch could not entail significant modification of existing facilities.[22]

Production extension refers to continuing to use assets currently devoted to production in another market—for example, brand names and reputation—for their current use, while also extending them for use in producing the relevant product.[23]

The third category of uncommitted entrants include firms that would newly gather the assets required to produce or sell the relevant product in response to a SSNIP, if they could do so without incurring significant sunk costs of entry and exit.[24]

Section 2

The competitive effects section, new to the 1992 Guidelines, is the heart of any effort to "tell a story" about the likely effects of a merger. There are a number of general implications of the competitive effects section, apart from specific issues of practical application.

Most significantly, the competitive effects analysis must be done in every case; and it is given equal weight in the overall analysis regardless of the post-merger level of concentration or the magnitude of the change in concentration resulting from the merger.[25] In addition, the competitive effects stories in the new Guidelines are representative, not exhaustive, and they are alternative rather than mutually exclusive. Thus, the analysis does not stop simply because coordinated interaction ("collusion" in the language of the 1984 Guidelines) is impossible in the relevant market. It also is necessary to consider whether the merger will lead to the unilateral exercise of market power.

Coordinated Interaction. The coordinated effects story is built around three elements of coordinated interaction: terms of coordination, detection, and punishment. Successful coordinated interaction is impossible without each of these elements.

Firms cannot engage in coordinated interaction unless there are some terms about which they can coordinate. But the terms of coordination need not perfectly replicate the monopoly outcome—they may be imperfect or incomplete so long as they have some output-reducing and price-increasing effect.

The importance of detection and punishment derives from the inherent instability of cartels. It is always more profitable for a firm to cheat on a cartel agreement than to abide by the agreement, as long as the firm is not caught and punished. Successful coordination, therefore, requires that deviations from any terms of coordination be detectable and punishable so that coordinating firms find it in their interests to abide by the terms of coordination rather than deviate from them.[26]

A merger will be regarded as likely to lessen competition through coordinated interaction if market conditions are conducive to each of these three elements and the merger, in effect, would make things worse by making coordinated interaction more likely, more successful, or more complete.[27] Conversely, a merger is unlikely to lessen competition through coordinated interaction if market conditions are not conducive to any one of the three elements, or the merger would not make coordinated interaction more likely, more successful, or more complete.

Without intending to create an inclusive list, the new Guidelines discuss the significance of a host of market factors that lead to or hinder firms from reaching terms of coordination, or detecting or punishing deviations from those terms. Most important, however is this section's message that analysis of whether a merger will lessen competition through coordinated interaction must relate specific market factors to the incentives of firms to maintain some price-elevating and output-restricting coordinated interaction.[28] Market factors are irrelevant to this analysis unless they relate to firms' incentives and abilities to reach terms of coordination, detect deviations from those terms, and punish those deviations.

The treatment of big buyers is a case in point. The relevance of big buyers to coordinated interaction does not stem from their sophistication or their self-proclaimed ability to protect themselves. Instead, the issue is whether sellers will have the incentive to deviate from terms of coordination because the gains from securing a large long-term contract outweigh any losses from being caught after the fact.[29] Big buyers may have other significance in the analysis of the merger. For example, they might have an ability to stake entrants with forward contracts, thereby increasing the likely sales opportunities available to entrants.[30] But these arguments must be analyzed in terms of how they fit within the Guidelines' framework.

*Unilateral Effects.*The concern in the Guidelines' unilateral effects section is that a merger may enable the merged firm, even though it is not a monopolist, to exercise market power without coordinating with its rivals. The nature of this unilateral effect, and the market factors that affect its likelihood and magnitude, depend on the characteristics that distinguish firms and shape their competitive interactions. The new Guidelines discuss unilateral effects in the context of two types of markets: differentiated product markets, where firms are distinguished by their products; and homogeneous product markets, where firms are distinguished by their capacities. Other characteristics, of course, may distinguish firms and shape their competitive interactions.[31]

Unilateral effects are a matter of concern only where the merger falls outside the safe harbor concentration ranges of Guidelines Section 1.5, and the combined share of the merging firms exceeds 35 percent.[32] Where these conditions are met, the Guidelines examine market factors beyond market concentration and market shares that may be relevant to the likelihood and magnitude of the merged firm's unilateral exercise of market power.

This analysis of market factors stands in sharp contrast to the leading firm proviso, the only explicit treatment of unilateral effects in the 1984 Guidelines. Under the leading firm proviso, the Department of Justice was likely to challenge any merger between a leading firm with at least 35 percent of the market and a competitor with at least 1 percent of the market. No inquiry was made into the likely effect of a such a merger or into market factors that might be relevant to that effect.[33]

In the differentiated products context, the new Guidelines recognize that every merger may make it profitable for the merged firm unilaterally to raise the price of one or both of the products now under its control (ignoring issues of entry and efficiencies). But unilateral effects warranting concern are likely only if (1) a substantial share of sales in the market is accounted for by consumers who regard the products of the merging firms as their first and second choices; and (2) repositioning of the product lines of other firms is unlikely.[34]

The new Guidelines consider the share of sales in the market accounted for by consumers who regard the products of

the merging firms as their first and second choices to be a measure of the "closeness" of the two products as substitutes.[35] Thus, the first of the two conditions in which unilateral effects are likely to warrant concern may be thought of as requiring that the products be sufficiently close substitutes.

This closeness requirement may be evaluated in many ways. Marketing survey data, bidding records, or other documents may provide information about consumers' actual first and second choices, depending on how the data are collected. Other indications of the relative closeness or distance of the products of the merging firms may come from econometric estimation or from industry sources discussing product niches, product segments, strategic groups of competitors, and the like.[36]

In the homogeneous product context, the Guidelines focus on whether the merged firm would find it profitable to suppress output and increase the price of the relevant product.[37] The capacity conditions of the other firms in the market will be of considerable practical significance in this context. Unilateral output suppression is likely only if other firms would not react to the output suppression by significantly expanding their own production. This reaction may be unlikely where there are binding capacity constraints that could not be economically relaxed within two years. Alternatively, a nonparty reaction may be unlikely, despite adequate excess capacity, if that excess capacity can be operated only at significantly greater cost.

Section 3

Only after first assessing market definition, measurement and concentration, and then the potential adverse competitive effects of the merger, do the Guidelines turn to entry analysis to assess whether the prospect of committed entry will deter an anticompetitive merger, or deter or counteract the competitive effects of concern. And entry must have this deterring or counteracting effect to be relevant to the issue of whether a merger will create or enhance market power or facilitate its exercise.

The new Guidelines describe an analytical process for evaluating the timeliness, likelihood, and sufficiency of possible committed entry. Entry is "timely" if it would achieve significant market impact within two years; "likely" if it would be profitable at *premerger* prices; and "sufficient" if it responds fully to the merger-induced sales opportunities. The most significant practical issues arise in the analysis of likelihood.

The competitive effects analysis must be done in every case; and it is given equal weight in the overall analysis regardless of the post-merger level of concentration or the magnitude of the change in concentration resulting from the merger.

The revised Guidelines analyze the likelihood of committed entry at *premerger* prices. The use of premerger prices follows from the fact that committed entry, by definition, is in for the long-term (defined by the expected life of the sunk investment). Further, entry, in order to be relevant, must deter or counteract the competitive effects of concern that otherwise would increase price above the competitive level.

The Guidelines' methodology for assessing the profitability, and therefore the likelihood, of entry is to compare the minimum viable scale (MVS) of entry to the likely sales opportunities available to the entrant. MVS is defined as "the smallest average annual level of sales that the committed entrant must persistently achieve for profitability at premerger prices."[38]

MVS may be estimated by asking knowledgeable business people what is the smallest output at which they could break even (in the economic sense) if they were guaranteed premerger prices. Care must be taken, however, to be sure that this estimation is performed with an entry alternative in mind that might practically be employed by an entrant, and that all phases of that entry alternative be considered.[39]

Conclusion

This article highlights only some of the issues that may be relevant to applying the new Horizontal Merger Guidelines in a given case. Many other issues are apparent from the text of the new Guidelines. Still others will arise as government and private sector practitioners gain experience in applying the new Guidelines. Careful reading and application of the new Guidelines should lead to better reasoned analysis of mergers. ●

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[1] *See* Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (April 2, 1992), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104 [hereinafter 1992 Guidelines]. The 1992 Guidelines update the Merger Guidelines issued by the Department of Justice in 1984 [hereinafter "1984 Guidelines"] and the Statement of Federal Trade Commission Concerning Horizontal Mergers issued in 1982. The National Association of Attorneys General (NAAG) has its own Horizontal Merger Guidelines, issued in 1987. This article does not consider issues arising under the NAAG Guidelines.

[2] Of course, this is not the only way to analyze the competitive implications of a merger. In theory at least, it would be preferable to measure elasticity of demand directly. *See, e.g.*, Landes & Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937 (1981); Baker & Bresnahan, *Estimating the Residual Demand Curve Facing a Single Firm*, 6 INT'L J. INDUS. ORG. 283 (1988). But where the "traditional" market-based analysis is employed, these five steps are each necessary and together sufficient. *See* 1992 Guidelines § 0.2.

[3] *See* 1992 Guidelines § 0.1.

[4] *See* 1992 Guidelines § 3.1.

[5] *See* 1992 Guidelines § 3.0.

[6] *See* 1984 Guidelines § 3.11.

[7] In the 1984 Guidelines, other market factors relating to the ease and profitably of collusion were regarded as "most like to be important where the Department's decision whether to challenge a merger is otherwise close." 1984 Guidelines § 3.4. Efficiencies had to be proven by "clear and convincing evidence." *Id.* § 3.5. The failing firm doctrine was characterized as a "long-established, but ambiguous doctrine" the elements of

which were to be construed "strictly." *Id.* § 5.1.

[8] *See* 1992 Merger Guidelines § 1.51.

[9] As in the 1984 Guidelines, safe harbors are defined as post-merger concentration as measured by the Herfindahl-Hirschman Index (HHI) of less than 1000; post-merger HHI between 1000 and 1800 with a change in the HHI resulting from the merger of less than 100; and post-merger concentration above 1800 with a change in the HHI resulting from the merger of less than 50.

[10] *Compare* 1992 Guidelines §§ 1.0–1.5 with 1984 Guidelines §§ 2.0–3.2. The 1984 Guidelines referred to the second step as "Identification of Firms that Produce the Relevant Product." 1984 Guidelines § 2.2. Since production substitutors, to use the term from the 1984 Guidelines, affect the market price without actually producing the relevant product, "market participants" is a more accurate description of these firms.

[11] *See* 1992 Guidelines § 1.11.

[12] *See* 1992 Guidelines §§ 1.11, 1.21.

[13] *See* 1992 Guidelines §§ 1.11, 1.21.

[14] *Compare* 1992 Guidelines § 1.3 *with* 1984 Guidelines § 2.2.

[15] *See* 1984 Guidelines § 2.23.

[16] *See* 1984 Guidelines § 2.21.

[17] *See* 1992 Guidelines § 1.31.

[18] *See* Froeb, *Evaluating Mergers in Durable Goods Industries*, 34 ANTITRUST BULL. 99, 103 (1989).

[19] *See* 1992 Guidelines § 1.32.

[20] Economic depreciation of the asset during its use is not regarded as a sunk cost. The difference in the value of the asset between alternative uses is calculated using the value of the depreciated asset in each use.

[21] *See* 1992 Guidelines § 1.32.

[22] *Compare* 1992 Guidelines § 1.321 with 1984 Guidelines § 2.21.

[23] *See* 1992 Guidelines § 1.321.

[24] *See* 1992 Guidelines § 1.322.

[25] *See 60 Minutes with the Honorable James F. Rill*, 61 ANTITRUST L.J. (forthcoming 1992).

[26] *See* 1992 Guidelines § 2.1.

[27] *See id.*

[28] *See* Rill, *supra* note 25.

[29] *See generally* Denis, *Market Power in Antitrust Merger Analysis: Refining the Collusion Hypothesis*, 60 ANTITRUST L.J. 829 (1992).

[30] *See* 1992 Guidelines § 3.3.

[31] For example, the Guidelines note that firms may be distinguished by their relative advantage in serving different customers or groups of customers. *See* 1992 Guidelines § 2.21 n.21.

[32] *See* 1992 Guidelines §§ 2.211, 2.22.

[33] *See* 1984 Guidelines § 3.12.

[34] *See* 1992 Guidelines § 2.21.

[35] *See id.*

[36] *See* Baker & Bresnahan, *The Gains from Merger or Collusion in Product-Differentiated Industries*, 33 J. INDUS. ECON. 427 (1985), suggesting an approach to econometric estimation.

[37] *See* 1992 Guidelines § 2.22.

[38] *See* 1992 Guidelines § 3.2.

[39] *See* 1992 Guidelines § 3.3.

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