International Merger Law

Events and commentary

No. 21 May, 1992
Author's Reprint

New U.S. Merger Enforcement Guidelines: Competitive effects

by Joseph J. Simons
Wachtell, Lipton, Rosen & Katz
New York, New York
Michael A. Williams
Vice President, Analysis Group, Inc.
Los Angeles, CA
R. Preston McAfee
Professor of Political Economy
University of Texas at Austin

The Department of Justice and the Federal Trade Commission state that the most significant revision to their newly issued 1992 Horizontal Merger Guidelines involves creation of the section entitled "The Potential Adverse Competitive Effects of Mergers" (hereinafter "Competitive Effects"). The purpose of this section is to explain more clearly the processes through which mergers may lead to adverse competitive effects. In the 1982 and 1984 Department of Justice Merger Guidelines, the analytical framework focused on the possibility of mergers increasing the likelihood of collusion. This focus caused practitioners to expend significant resources developing arguments as to why collusion was not possible, even though concentration might be high, with respect to the post-merger marketplace. Where practitioners were successful in showing that collusion was unlikely, the tendency was then to assume, at least on the part of most practitioners, that the merger could have no adverse effects and would go unchallenged. This assumption, however, is contrary to the weight of economic theory and evidence. The Competitive Effects section of the 1992 Merger Guidelines appears to be an attempt to clarify that mergers may adversely affect competition in ways other than through the facilitation of collusion.

Delineation of adverse effects other than collusion is an admirable goal and should be pursued. Unfortunately, the revisions embodied in the 1992 Merger Guidelines concerning competitive effects provide too little guidance and too much confusion. Perhaps that is unavoidable at this stage in our understanding of these other processes. In addition, probably the greatest contribution of the 1982 Merger Guidelines was its use of an integrated approach to merger analysis, including market definition. Those guidelines adopted the unifying theme of prohibiting mergers that facilitate collusion and geared their market definition analysis specifically to that purpose. This approach added great theoretical rigor to what had previously been a notoriously ad hoc process. The 1992 Guidelines appear to abandon this integrated approach by applying market definition and concentration analyses geared to deterring collusion to other types of behavior that are probably incongruous with such standards.

Coordinated interaction versus unilateral effects

Part of the confusion caused by the new revisions is due to the introduction of new terminology ambiguously defined. The 1992 Guidelines divide the universe of the possible adverse competitive effects of mergers into two categories: "coordinated interaction" and "unilateral effects." Coordinated interaction is defined as "actions by a group of firms that are profitable for each of them only as a result of the accommodating reactions of others." This category appears to be merely a new description for the types of conduct that the previous guidelines had already addressed, namely tacit and overt collusion. The 1992 Guidelines, however, state that coordinated interaction includes tacit and overt collusion, suggesting that other types of conduct are implicated as well. Economic theory does not offer any other type of conduct beyond collusion that fits this description. The head of the Antitrust Division has previously mentioned "price leadership" and "concerted strategic retaliation" in conjunction with tacit and overt collusion as within the coordinated interaction penumbra. Most economists, however, would probably consider both price leadership and concerted retaliation merely as subsets of tacit or overt collusion.

The second category of competitive effects, unilateral effects, is much more ambiguous. One view of the section

of the 1992 Guidelines dealing with unilateral effects is that it re-packaged the leading firm proviso contained in the 1984 Guidelines. Alternatively, one could interpret the 1992 Merger Guidelines to cover a range of behavior not suggested previously. There are some indications that the FTC will read the 1992 Guidelines the former way, while the Department of Justice will interpret them the latter way.

The Unilateral Effects section of the 1992 Merger Guidelines begins:

> A merger may diminish competition even if it does not lead to increased likelihood of successful coordinated interaction, because merging firms may find it profitable to alter their behavior unilaterally following the acquisition by elevating price and suppressing output. Unilateral competitive effects can arise in a variety of different settings. In each setting, particular other factors describing the relevant market affect the likelihood of unilateral competitive effects. The settings differ by the primary characteristics that distinguish firms and shape the nature of their competition.

The section then goes on to discuss two cases, one involving differentiated products and one involving undifferentiated products. Both concern what could be characterized as variations on the dominant firm or leading firm theme with different factors contributing to the dominance of the firm in question.

In the differentiated scenario, the products of the merging firms are so differentiated from the products of other producers in the market that the merger will enable the merged firm to raise the price of one or both of its products post-acquisition. This is essentially a description of a merger to monopoly. In the undifferentiated product scenario, the capacities of the other firms in the market are so limited that they could not defeat a price increase by the merged firm even if they sought to do so. In both instances, one of the threshold elements is that the merging firms have a combined market share of 35%, which is exactly the same percentage that triggered the leading firm proviso in the 1982 and 1984 Merger Guidelines. Moreover, the 1992 Merger Guidelines have otherwise eliminated any other suggestion of the leading firm proviso. One could thus argue that the new section on unilateral behavior is merely a clarification and expansion of the leading firm proviso, providing possible mechanisms by which a leading firm has market power.

Alternatively, one could argue that the Competitive Effects section encompasses behavior not considered in the 1984 Merger Guidelines. In the overview to the Competitive Effects section, the 1992 Guidelines state that this section "considers some of the potential adverse competitive effects of mergers" and that "mergers will be analyzed in terms of as many potential adverse competitive effects as are appropriate." Thus, the Guidelines suggest that mergers will be examined for anticompetitive effects resulting from any possible behavior consistent with the firms' competitive environment.

The types of behavior that could be implicated by the unilateral effects section are probably best examined in the context of static oligopoly models. In these static models, competition is structured as a one-period game so that there is no interaction over time. Multiperiod oligopoly models can be characterized as concentrating on tacit collusion.

The fundamental static model in oligopoly theory is the Cournot model, which involves homogeneous goods. In the Cournot model, firms set their own outputs (or capacities) assuming other firms cannot react and the resulting prices are those that clear the market given total output. Under this model, equilibrium prices are higher than the competitive model but below monopoly levels. The degree to which Cournot prices are closer to competitive rather than monopoly prices depends on the number of firms that are competitively significant. The greater the number of such firms, the closer the prices move toward the competitive level.

For differentiated products, a standard static model is the Bertrand model. In this model, each firm's product is differentiated from that of its competitors so that all firms face somewhat downward sloping demand curves. In addition, the product of each firm may be a much closer substitute for the product of some firms than for others.

The impact of horizontal mergers in differentiated Bertrand models can be determined by comparing the residual demand elasticities facing the merging firms pre- and post-merger. Where demand becomes more inelastic after the merger, prices will rise and the closer the products of the merging firms are to each other, the greater the increase will be. In such a case, one could define the market to include only the merging firms since they will be able to raise price even if other firms attempt to expand output. Under these conditions, it would make little sense to define the markets more broadly based upon other similar products rather than the two merging firms because the concentration in the more broadly defined market would bear no necessary relationship to the likelihood of a price increase from the merger.

An article written by former Deputy Assistant Attorney General Robert Willig, one of the primary drafters of the revised guidelines, is at least suggestive that both of these static models were contemplated by the Department of Justice. Willig's discussion of differentiated Bertrand is quite similar to the new section in the Merger Guidelines dealing with unilateral effects involving differentiated products. In addition, Willig's article provides a model involving differentiated products in which reliance on market shares is appropriate under very specific assumptions. This may have been an attempt to justify the

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application of the standard methodology of the Merger Guidelines to the differentiated Bertrand situation. Unfortunately, the assumptions of Willig's model are probably not of general applicability and such an application is of questionable validity. Moreover, the market definition in the 1992 Merger Guidelines is inappropriate for the differentiated Bertrand model.

Because the 1992 Merger Guidelines do not mention Cournot or Bertrand models explicitly, it is also possible to interpret the new Competitive Effects section as ignoring such behavior entirely and merely clarifying the leading firm proviso. Commissioner Azcuenaga's statement dissenting from the issuance of the 1992 Merger Guidelines may be an indication that she and possibly other commissioners will adopt this less expansive interpretation.

Has the integrated approach to merger analysis been abandoned?

Prior to 1982, there was much confusion in merger analysis in general and in market definition in particular. A major contributing factor was that neither the courts nor the enforcement agencies articulated a precise goal of merger analysis, but in fact offered numerous competing goals. The courts seemed to focus at times on consumer welfare and at other times on ensuring the survival of small firms and atomistic markets. In those instances in which consumer welfare was the primary focus, the courts spoke vaguely about the inherently anticompetitive effect of mergers in markets characterized by relatively small numbers of firms without specifying any behavioral assumptions of those firms. The courts thus never specified the mechanism by which a merger might increase price (e.g. explicit collusion, tacit collusion or noncooperative behavior). Both the courts and enforcement authorities had applied the same market definition and concentration standards to all mergers without any thought as to how an individual merger might affect competition.

By focusing on collusion, the 1982 Merger Guidelines were able to create an integrated and rigorous framework for merger analysis. The market definition and consideration of "Other Factors" were designed specifically for dealing with the collusion hypothesis. Thus, the 1982 Merger Guidelines were the first internally consistent analysis of mergers with an explicit behavioral theory. The 1982 Guidelines, largely for this reason, have been widely credited with a major contribution to merger analysis. The 1982 Merger Guidelines neglected, however, to account for the other types of behavioral mechanisms through which mergers can adversely affect competition. The Competitive Effects section of the 1992 Merger Guidelines may represent an attempt to deal with other behavioral mechanisms. If the new guidelines are read broadly to cover other types of behavioral mechanisms, then they have abandoned the integrated approach and much of the rigor introduced with the 1982 Merger Guidelines. If they are read more narrowly just to clarify the leading or dominant firm models, then the consistency of the overall approach is retained.

The 1982, 1984 and 1992 Merger Guidelines all retain a multistage approach to merger analysis. First, the market is defined, then concentration is calculated and finally, the likely competitive effects are evaluated for possible anticompetitive effects in light of the concentration and other characteristics of the market. This multistage framework is suitable for analyzing collusion that may result from a merger because all firms in the market are assumed to be acting as a unified group when adverse effects arise. Under such circumstances, the number of firms in the group does not affect the behavior of the group and thus market definition can be done independently of the analysis of concentration and the resulting equilibrium price. For Cournot behavior, however, the number of firms in a provisional or candidate market does affect the group's expected performance. As a result, defining the market necessarily determines the equilibrium price effect of the merger and an additional, separate analysis of concentration is superfluous. Thus, horizontal merger analysis for markets characterized by Cournot behavior should be a single stage exercise, in contrast to the multistage framework of the Merger Guidelines. As discussed above, differentiated products that approximate the Bertrand model would also require only a single stage analysis.

Unfortunately, there is no theoretically consistent and empirically verified framework for analyzing mergers in markets characterized by Cournot or Bertrand behavior. We recommend, however, that rather than attempt to graft the framework of the Guidelines, which is geared for collusion, onto the analysis of mergers in these other types of markets, a better approach would be to recognize the void and begin the process of seeking to fill it. The 1992 Merger Guidelines create an additional problem relating to their use of nonstandard language. In particular, the terms "coordinated" and "unilateral" are not standard in oligopoly theory so that ambiguity and confusion in their usage will undoubtedly arise.

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