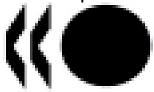

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# ROUNDTABLE ON SUBSTANTIVE CRITERIA USED FOR MERGER ASSESSMENT

**-- Note by the United States --**

*This document is submitted by the United States Delegation to the Competition Committee FOR DISCUSSION under Item XIII at its forthcoming meeting on 23-24 October 2002.*

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**ROUNDTABLE ON SUBSTANTIVE CRITERIA USED FOR MERGER ASSESSMENT**

***Note by the United States***

1. The United States uses a "substantial lessening of competition" test for merger analysis. Mergers are prohibited if their effect may be "substantially to lessen competition, or to tend to create a monopoly " "in any line of commerce… in any section of the country." Clayton Act §7, 15 U.S.C. § 18. Mergers may also be challenged under the Sherman Act, 15 U.S.C. § 1 or the Federal Trade Commission Act, 15 U.S.C. § 45; the analytical framework would be the same.

2. The DOJ and FTC analyse mergers using the analytical framework contained in the HORIZONTAL MERGER GUIDELINES issued by the agencies.[1] The Guidelines reflect the analytical framework of analysis of horizontal mergers under United States merger law.[2] The ensuing discussion primarily uses the language of the Guidelines to explain the substantive test employed in United States merger law.

3. The goal of the antitrust laws is to protect competition, not competitors. *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977). The unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise. Such a "lessening of competition" would lead to reduce output and higher prices, the evils at which the law is directed.

## 1. Market Power

4. Market power for a seller is the ability profitably to maintain prices above competitive levels for a significant period of time. In some circumstances, a sole seller (a "monopolist") of a product with no good substitutes can maintain a selling price that is above the level that would prevail if the market were competitive. Similarly, in some circumstances, where only a few firms account for most of the sales of a product, those firms can exercise market power, perhaps even approximating the performance of a monopolist, by either explicitly or implicitly co-ordinating their actions. Circumstances also may permit a single firm, not a monopolist, to exercise market power through unilateral or non-co-ordinate conduct -- conduct the success of which does not rely on the concurrence of other firms in the market or on co-ordinated responses by those firms. In any case, the result of the exercise of market power is a transfer of wealth from buyers to sellers and a misallocation of resources.

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[1] U.S. Department of Justice and Federal Trade Commission, HORIZONTAL MERGER GUIDELINES (1992, revised 1997), hereinafter, "GUIDELINES."

[2] Non-horizontal mergers are analysed under the framework of the NON-HORIZONTAL MERGER GUIDELINES, originally issued as Section 4 of the "U.S. Department of Justice Merger Guidelines," June 14, 1984 (All other sections of the 1984 Merger Guidelines have been superseded by the "HORIZONTAL MERGER GUIDELINES" issued April 2, 1992, and revised April 8, 1997, by the U.S. Department of Justice and the Federal Trade Commission.) There are also guidelines for joint ventures and similar arrangements. Federal Trade Commission and U.S. Department of Justice, ANTITRUST GUIDELINES FOR COLLABORATIONS AMONG COMPETITORS (2000).

## 2. Competitive Effects of a Merger

5. In the United States, the agencies take an economically driven, consumer welfare approach to merger review whereby the agencies evaluate the likely net effect of a transaction on price and output. The analytical approach to merger review recognises consumer benefits by pursuing merger enforcement only against mergers likely to be harmful, while otherwise relying on market forces to operate (including through lawful mergers) to benefit consumers.

6. While challenging competitively harmful mergers, the agencies seek to avoid unnecessary interference with the larger universe of mergers that are either competitively beneficial or neutral. In implementing this objective, however, the Guidelines reflect the congressional intent that merger enforcement should interdict competitive problems in their incipiency.

7. The agencies assess whether the merger, in light of market concentration and other factors that characterise the market, raises concern about potential adverse competitive effects. A merger may diminish competition by enabling the firms selling in the relevant market more likely, more successfully, or more completely to engage in co-ordinated interaction that harms consumers. Lessening of competition through co-ordinated interaction is discussed in section 2.1 of the Guidelines and below. A merger may diminish competition even if it does not lead to increase likelihood of successful co-ordinated interaction, because merging firms may find it profitable to alter their behaviour unilaterally following the merger by elevating price and suppressing output. Lessening of competition through unilateral effects is discussed in section 2.2 of the Guidelines and below.

## 3. Efficiencies

8. First, the law takes account of efficiency gains by employing a standard under which mergers do not need formal approval of the government -- rather; all mergers are lawful unless they violate the statute. Thus, "[w]hile challenging competitively harmful mergers, the Agenc[ies] seek[] to avoid unnecessary interference with the larger universe of mergers that are either competitively beneficial or neutral." GUIDELINES 0.1

9. Second, as the Guidelines describe, the agencies undertake a specific analysis of efficiency issues. In 1997, the Department of justice and the Federal Trade Commission revised a portion of their joint Horizontal Merger Guidelines to clarify how the agencies analyse claims that a merger is likely to lower costs, improve product quality, or otherwise achieve efficiencies. The revisions make clear that the agencies will take efficiencies into account as part of their analysis of the competitive effects of the merger. The revisions also provide explicit guidance on issues such as: how the agencies determine if the claimed efficiencies are properly attributable to the merger; what the parties must do to substantiate their efficiencies claims; the circumstances, as a practical matter, in which the agencies are likely to find efficiencies claims persuasive; and the circumstances under which consideration will be given to out-of-market efficiencies and to in-market efficiencies that are not expected to have short-term, direct effects on prices. Efficiencies are discussed in section 4 of the Guidelines and below.

## 4. Failing firms

10. The agencies assess whether, but for the merger, either party to the transaction would be likely to fail, causing its assets to exit the market. The theory is that "[a] merger is not likely to create or enhance market power or to facilitate its exercise, if imminent failure of one of the merging firms would cause the assets of that firm to exit the relevant market. In such circumstances, post-merger performance in the

relevant market may be no worse than market performance had the merger been blocked and the assets left the market." GUIDELINES 5.0 *See below* for a description of the analytical steps in applying this principle.

## 5. Application of the Substantive Standard

11. Before discussing in more detail the application of the Guidelines, this paper will discuss how the agencies would likely apply the substantial lessening of competition test to the four hypothetical mergers described in section III.1(a-d) of the "Suggested Issues and Questions for Consideration in Country Submissions."

### *(a) "a series of small mergers which appears to be leading to the creation of a firm having significant market power, e.g. a series of small mergers used to build a chain of distributors"*

12. The U.S. agencies typically evaluate each individual transaction independently on its own merits, asking whether the transaction at issue, in and of itself, will lead directly to anticompetitive effects (*e.g.,* price increases or output reductions). Generally, concentration trends alone "are irrelevant except insofar as they might suggest that somewhat more severe antimerger rules be applied when an industry reaches or approaches a particular level or concentration or once a number of sellers has reached a critical point. In that event it is the present market structure that is critical, and not the history of its getting there." Areeda, Solow & Hovenkamp, IV Antitrust Law ¶916a (1998). "There is some reason to believe that, starting with monopoly, the competitive gains from increasing the number of sellers decline steadily and substantially. That is, there is a greater gain in competitive pricing from increasing the number of sellers from one to two than from two to three, and so on. At the same time, there is every reason to suppose that there is a critical threshold, that as one moves from monopoly to an increasing number of sellers, each seller at some point will begin to ignore its own influence on price. The question is what that critical threshold is." *Id.* at ¶927b.

13. The rapid consolidation of radio stations following the liberalisation of that industry in the 1996 Telecommunications Act is an example of this scenario. Prior to the Act, the amount of radio consolidation that was allowed by statute was so small that the antitrust laws never really came into play. The primary reason for the huge radio merger wave after passage of the Act -- over a thousand mergers, of which about 50 were investigated by the DOJ in the first year -- was the pent-up demand that resulted from the previous statutory limitations on radio ownership. The DOJ brought three cases in the first year, based on unilateral effects theories, where in particular geographic markets the merged entities would have held post-merger market shares of advertising dollars of 53%, 63%, and over 40%; in each case, consent decrees resulted in divestitures of particular stations and reductions of these market shares.

### *(b) "in the pre-merger situation there is little in the way of competition in the pertinent market — e.g. the market is currently regulated but is scheduled to be liberalised; few sellers have much in the way of excess capacity and there are significant barriers to entry; there is a tight oligopoly characterised by a high degree of conscious parallelism; or some other factor has the effect of reducing current competition to a very low level"*

14. Although §7 of the Clayton Act refers to mergers that may "lessen" competition, the statute has been interpreted to prohibit mergers that worsen the competitive health of markets that already exhibit weak competition and mergers that, while preserving the status quo, forestall future competition. Analogous language in §2 of the Sherman Act, which makes it unlawful to monopolise or attempt to monopolise, has been read to prohibit efforts to maintain a monopoly. *See id.* at ¶907. "Clearly the term 'lessen competition' also encompasses the merger that promises to make a bad situation even worse." Id. at ¶916c. It is important to note, however, that the agencies are enforcement bodies, not regulators. Once

a violation of the Clayton Act is established, the goal is not to review the market and decide how it would best operate or to resolve problems that were not caused by the transaction. Instead, the goal is to remedy the violation by maintaining competition at its pre-merger level.

### *(c)* *"a merger is expected to lead to anticompetitive co-ordination among firms among whom there are no* **structural** *links"*

15. This hypothetical presents the standard co-ordinated effect scenario. The presence of "structural links" has never been an element of U.S. merger law as it applies to these cases. The approach of the agencies to co-ordinated effects cases, described in greater detail below, is based on the premise that in order for firms to co-ordinate their business practices, they must be able to do three things: 1) reach terms of co-ordination that are profitable to the firms involved, 2) detect deviations that would undermine co-ordination, and 3) punish any such cheating that occurs. There are many different market conditions that can facilitate co-ordinated interaction. In the context of merger review, a fundamental issue is how one or more market conditions could interact with a change in market structure to increase the likelihood and success of post-merger co-ordinated interaction.

16. A good example of a litigated co-ordinated effects case is *Federal Trade Commission v. Cardinal Health*, 12 F.Supp.2d 34 (D.D.C. 1998). In this case two pairs of drug wholesalers proposed to merge. Cardinal Health sought to merge with Bergen-Brunswick Corp. and McKesson Corp. sought to merge with AmeriSource Health. The FTC brought two separate actions and the District Court consolidated the cases. The Court granted a motion for preliminary injunction. Despite finding that the defendants presented credible evidence to rebut the *prima facie* case, the court held the government's competitive effects arguments and evidence to be more persuasive. The court highlighted three bodies of evidence. First, documents showed that the defendants sought to merge in order to achieve "rational" pricing in a market that was plagued with excess capacity. Second, the government produced evidence showing that prices fell after an earlier proposed merger between two of the defendants was challenged and withdrawn. Third, the government showed evidence of present co-ordinated pricing arising from the inclusion of most-favoured-nation clauses in customer contracts.

<u>Prima Facie Case</u>:

17. The court noted that the proposed mergers would reduce the number of national wholesalers from four to two, giving them control of 80% of the wholesale market. "Given the projected increases in the HHI, the Court must presume that the proposed mergers pose a risk to competition."

| **Market shares** | | **HHI** | |
|---|---|---|---|
| McKesson | 24.9 % | Pre-mergers | 1648 |
| Bergen-Brunswick | 22.4 % | Post-both mergers | 3079 |
| Cardinal | 17.5 % | Change (both mergers) | + 1648 |
| AmeriSource | 12.3 % | | |

## 6. Co-ordinated Effects Analysis:

1. <u>History of co-ordination</u>: Contracts between three of the defendants and customers included most-favoured-nation clauses. One of the contracts between a hospital purchasing group and three of the four defendants set a floor on prices that the defendants would offer to other hospitals and guaranteed that the purchasing group would receive the same price from each of the defendants. There was evidence that when the defendants believed that one of them had

offered lower prices, they would report that to the buying group who got the outlaw to bring prices back to the agreed upon pricing matrix. Because of these agreements, the court believed that three of the four defendants engaged in a "subtle form of price stabilisation" that could assist the merging firms to tacitly collude.

2. Entry impediments: The court stated that "[a] court's finding that there exists ease of entry into the relevant product market can be sufficient to offset the government's *prima facie* case of anti-competitiveness." However, the court concluded that the record developed at trial was not strong enough to find that entry could rebut the government's *prima facie* case.

3. Small buyers: The court recognised that the sophistication and bargaining power of buyers is a significant factor in assessing the effects of a merger. While the evidence at trial showed that some large buyers and buyer co-operatives monitored prices, the court concluded that the size and sophistication of the buyers could not rebut the government's *prima facie* case. The court found that the market as a whole was fragmented, consisting of numerous independent pharmacies and smaller hospitals. Because of the large number of customers and the interchangeability of contracts, it was not clear how important each individual customer — and particularly a small or medium-sized customer — was to the defendants.

***(d) "although the merged entity will not have a dominant position (or something closely analogous), it is nonetheless expected to be able to profitably raise price post-merger despite expected increases in output by competitors"***

18. This hypothetical presents a unilateral effect scenario, as described in greater detail below. An example of a unilateral effect case is the DOJ's June 2000 suit to block WorldCom's acquisition of Sprint. In several of the markets of concern in that case, WorldCom and Sprint were the second and third largest firms after AT&T, which even after the merger would have retained the largest market share. In the residential long distance U.S. telephone market, for example, WorldCom had a 19% share, Sprint had 8%, and the "Big 3" (WorldCom, Sprint, and AT&T) had 80%. Similar market shares were present in the market for international private line services between the U.S. and more than 60 foreign countries, the market for data network services to large business customers in the U.S., and for international long distance services between the U.S. and more than 50 foreign countries.

## 7. The Guidelines' Analytical Framework

19. The analytical framework is forward-looking. The agencies employ a five-step analytical process of assessing market concentration, potential adverse competitive effects, entry, efficiency and failure as a tool that allows them to answer the ultimate inquiry in merger analysis: whether the merger is likely to create or enhance market power or to facilitate its exercise. Moreover, as noted below, the analytical framework entails explicit consideration of "changing market conditions" because "recent or ongoing changes in the market may indicate that the current market share of a particular firm either understates or overstates the firm's future competitive significance." Thus, the agencies "consider reasonably predictable effects of recent or ongoing changes in market conditions in interpreting market concentration and market share data." GUIDELINES 1.521

20. The Guidelines describe a five-step analytical process that is employed in determining whether to challenge a horizontal merger.

1. First, the agencies assess whether the merger would significantly increase concentration and result in a concentrated market, properly defined and measured.

2. Second, the agencies assess whether the merger, in light of market concentration and other factors that characterise the market, raises concern about potential adverse competitive effects.

3. Third, the agencies assess whether entry would be timely, likely and sufficient either to deter or to counteract the competitive effects of concern.

4. Fourth, the agencies assess any efficiency gains that reasonably cannot be achieved by the parties through other means.

5. Finally, the agencies assess whether, but for the merger, either party to the transaction would be likely to fail, causing its assets to exit the market.

### *7.1 Definition of Markets and Assessment of Concentration*

"First, the agencies assess whether the merger would significantly increase concentration and result in a concentrated market, properly defined and measured."

21. A merger is unlikely to create or enhance market power or to facilitate its exercise unless it significantly increases concentration and results in a concentrated market, properly defined and measured. Mergers that either do not significantly increase concentration or do not result in a concentrated market ordinarily require no further analysis.

22. The analytic process described here ensures that the agencies evaluate the likely competitive impact of a merger within the context of economically meaningful markets - - *i.e.*, markets that could be subject to the exercise of market power. Accordingly, for each product or service (hereafter "product") of each merging firm, the agencies seek to define a market in which firms could effectively exercise market power if they were able to co-ordinate their actions.

23. Market definition focuses solely on demand substitution factors -- *i.e.*, possible consumer responses. Supply substitution factors -- *i.e.*, possible production responses -- are considered elsewhere in the Guidelines in the identification of firms that participate in the relevant market and the analysis of entry. If the process of market definition and market measurement identifies one or more relevant markets in which the merging firms are both participants, then the merger is considered to be horizontal.

24. After market participants have been identified and market shares measured, then market concentration is assessed. Market concentration is a function of the number of firms in a market and their respective market shares. As an aid to the interpretation of market data, the agencies use the Herfindahl-Hirschman Index ("HHI") of market concentration. The HHI is calculated by summing the squares of the individual market shares of all the participants. Unlike the four-firm concentration ratio, the HHI reflects both the distribution of the market shares of the top four firms and the composition of the market outside the four firms. It also gives proportionately greater weight to the market shares of the larger firms, in accord with their relative importance in competitive interactions.

25. The agencies divide the spectrum of market concentration as measured by the HHI into three regions that can be broadly characterised as unconcentrated (HHI below 1000), moderately concentrated (HHI between 1000 and 1800), and highly concentrated (HHI above 1800). Although the resulting regions

provide a useful framework for merger analysis, the numerical divisions suggest greater precision than is possible with the available economic tools and information. In addition, as discussed below, market share concentration is only the starting point for analysis -- concentration in and of itself is insufficient to justify an enforcement action.

26. General Standards. In evaluating horizontal mergers, the agencies consider both the post-merger market concentration and the increase in concentration resulting from the merger. Market concentration is a useful indicator of the likely potential competitive effect of a merger. The general standards for horizontal mergers are as follows:

a) Post-Merger HHI Below 1000. The agencies regard markets in this region to be unconcentrated. Mergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and ordinarily require no further analysis.

b) Post-Merger HHI Between 1000 and 1800. The agencies regard markets in this region to be moderately concentrated. Mergers producing an increase in the HHI of less than 100 points in moderately concentrated markets post-merger are unlikely to have adverse competitive consequences and ordinarily require no further analysis. Mergers producing an increase in the HHI of more than 100 points in moderately concentrated markets post-merger potentially raise significant competitive concerns depending on the factors set forth in the competitive effects analysis of the Guidelines.

c) Post-Merger HHI Above 1800. The agencies regard markets in this region to be highly concentrated. Mergers producing an increase in the HHI of less than 50 points, even in highly concentrated markets post-merger, are unlikely to have adverse competitive consequences and ordinarily require no further analysis. Mergers producing an increase in the HHI of more than 50 points in highly concentrated markets post-merger potentially raise significant competitive concerns, depending on the factors set forth in the competitive effects analysis of the Guidelines. Where the post-merger HHI exceeds 1800, it will be presumed that mergers producing an increase in the HHI of more than 100 points are likely to create or enhance market power or facilitate its exercise. The presumption may be overcome by a showing that factors set forth in the competitive effects analysis of the Guidelines make it unlikely that the merger will create or enhance market power or facilitate its exercise, in light of market concentration and market shares.

27. Factors affecting the Significance of Market Shares and Concentration. The post-merger level of market concentration and the change in concentration resulting from a merger affect the degree to which a merger raises competitive concerns. However, in some situations, market share and market concentration data may either understate or overstate the likely future competitive significance of a firm or firms in the market or the impact of a merger. The following are examples of such situations.

(a) Changing Market Conditions. Market concentration and market share data of necessity are based on historical evidence. However, recent or ongoing changes in the market may indicate that the current market share of a particular firm either understates or overstates the firm's future competitive significance. For example, if a new technology that is important to long-term competitive viability is available to other firms in the market, but is not available to a particular firm, the agencies may conclude that the historical market share of that firm overstates its future competitive significance. The agencies will consider reasonably predictable effects of recent or ongoing changes in market conditions in interpreting market concentration and market share data.

(b) Degree of Difference between the Products and Locations in the Market and Substitutes outside the Market. All else equals, the magnitude of potential competitive harm from a merger is greater if a hypothetical monopolist would raise price within the relevant market by substantially more than a "small but significant and nontransitory" amount. This may occur when the demand substitutes outside the relevant market, as a group, are not close substitutes for the products and locations within the relevant market. There thus may be a wide gap in the chain of demand substitutes at the edge of the product and geographic market. Under such circumstances, more market power is at stake in the relevant market than in a market in which a hypothetical monopolist would raise price by exactly five percent.

### *7.2 Evaluation of Potential Adverse Competitive Effects*

> "Second, the agencies assess whether the merger, in light of market concentration and other factors that characterise the market, raises concern about potential adverse competitive effects."

28. Other things being equal, market concentration affects the likelihood that one firm, or a small group of firms, could successfully exercise market power. The smaller the percentage of total supply that a firm controls, the more severely it must restrict its own output in order to produce a given price increase, and the less likely it is that an output restriction will be profitable. If collective action is necessary for the exercise of market power, as the number of firms necessary to control a given percentage of total supply decreases, the difficulties and costs of reaching and enforcing an understanding with respect to the control of that supply might be reduced. However, market share and concentration data provide only the starting point for analysing the competitive impact of a merger. Before determining whether to challenge a merger, the agencies also will assess the other market factors that pertain to competitive effects, as well as entry, efficiencies and failure.

#### *7.2.1 Lessening of Competition through Co-ordinated Interaction*

29. A merger may diminish competition by enabling the firms selling in the relevant market more likely, more successfully, or more completely to engage in co-ordinated interaction that harms consumers. Co-ordinated interaction is comprised of actions by a group of firms that are profitable for each of them only as a result of the accommodating reactions of the others. This behaviour includes tacit or express collusion, and may or may not be lawful in and of itself.

30. Successful co-ordinated interaction entails reaching terms of co-ordination that are profitable to the firms involved and an ability to detect and punish deviations that would undermine the co-ordinated interaction. Detection and punishment of deviations ensure that co-ordinating firms will find it more profitable to adhere to the terms of co-ordination than to pursue short-term profits from deviating, given the costs of reprisal. In this phase of the analysis, the agencies will examine the extent to which post-merger market conditions are conducive to reaching terms of co-ordination, detecting deviations from those terms, and punishing such deviations. Depending upon the circumstances, the following market factors, among others, may be relevant: the availability of key information concerning market conditions, transactions and individual competitors; the extent of firm and product heterogeneity; pricing or marketing practices typically employed by firms in the market; the characteristics of buyers and sellers; and the characteristics of typical transactions.

31. Certain market conditions that are conducive to reaching terms of co-ordination also may be conducive to detecting or punishing deviations from those terms. For example, the extent of information

available to firms in the market, or the extent of homogeneity, may be relevant to both the ability to reach terms of co-ordination and to detect or punish deviations from those terms. The extent to which any specific market condition will be relevant to one or more of the conditions necessary to co-ordinated interaction will depend on the circumstances of the particular case.

32. It is likely that market conditions are conducive to co-ordinated interaction when the firms in the market previously have engaged in express collusion and when the salient characteristics of the market have not changed appreciably since the most recent such incident. Previous express collusion in another geographic market will have the same weight when the salient characteristics of that other market at the time of the collusion are comparable to those in the relevant market.

33. In analysing the effect of a particular merger on co-ordinated interaction, the agencies are mindful of the difficulties of predicting likely future behaviour based on the types of incomplete and sometimes contradictory information typically generated in merger investigations. Whether a merger is likely to diminish competition by enabling firms more likely, more successfully or more completely to engage in co-ordinated interaction depends on whether market conditions, on the whole, are conducive to reaching terms of co-ordination and detecting and punishing deviations from those terms. In some circumstances, for example, co-ordinated interaction can be effectively prevented or limited by maverick firms — firms that have a greater economic incentive to deviate from the terms of co-ordination than do most of their rivals (*e.g.*, firms that are unusually disruptive and competitive influences in the market).

### *7.2.2 Lessening of Competition through Unilateral Effects*

34. A merger may diminish competition even if it does not lead to increased likelihood of successful co-ordinated interaction, because the merging firms may find it profitable to alter their behaviour 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.

a) Firms Distinguished Primarily by Differentiated Products. In some markets the products are differentiated, so that products sold by different participants in the market are not perfect substitutes for one another. Moreover, different products in the market may vary in the degree of their substitutability for one another. In this setting, competition may be non-uniform (*i.e.*, localised), so that individual sellers compete more directly with those rivals selling closer substitutes.

35. A merger between firms in a market for differentiated products may diminish competition by enabling the merged firm to profit by unilaterally raising the price of one or both products above the premerger level. Some of the sales loss due to the price rise merely will be diverted to the product of the merger partner and, depending on relative margins, capturing such sales loss through merger may make the price increase profitable even though it would not have been profitable premerger. Substantial unilateral price elevation in a market for differentiated products requires that there be a significant share of sales in the market accounted for by consumers who regard the products of the merging firms as their first and second choices, and that repositioning of the non-parties' product lines to replace the localised competition lost through the merger be unlikely. The price rise will be greater the closer substitutes are the products of the merging firms, *i.e.*, the more the buyers of one product consider the other product to be their next choice.

b) Firms Distinguished Primarily by Their Capacities. Where products are relatively undifferentiated and capacity primarily distinguishes firms and shapes the nature of their competition, the merged firm may find it profitable unilaterally to raise price and suppress output. The merger provides the merged firm a larger base of sales on which to enjoy the resulting price rise and also eliminates a competitor to which customers otherwise would have diverted their sales. Where the merging firms have a combined market share of at least thirty-five percent, merged firms may find it profitable to raise price and reduce joint output below the sum of their premerger outputs because the lost markups on the foregone sales may be outweighed by the resulting price increase on the merged base of sales.

36. This unilateral effect is unlikely unless a sufficiently large number of the merged firm's customers would not be able to find economical alternative sources of supply, *i.e.*, competitors of the merged firm likely would not respond to the price increase and output reduction by the merged firm with increases in their own outputs sufficient in the aggregate to make the unilateral action of the merged firm unprofitable. Such non-party expansion is unlikely if those firms face binding capacity constraints that could not be economically relaxed within two years or if existing excess capacity is significantly more costly to operate than capacity currently in use.

### *7.3 Entry Analysis*

"Third, the agencies assess whether entry would be timely, likely and sufficient either to deter or to counteract the competitive effects of concern."

37. A merger is not likely to create or enhance market power or to facilitate its exercise, if entry into the market is so easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels. Such entry likely will deter an anticompetitive merger in its incipiency, or deter or counteract the competitive effects of concern.

38. Entry is that easy if entry would be timely, likely, and sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern. In markets where entry is that easy (*i.e.*, where entry passes these tests of timeliness, likelihood, and sufficiency), the merger raises no antitrust concern and ordinarily requires no further analysis.

39. The committed entry treated here is defined as new competition that requires expenditure of significant sunk costs of entry and exit. The agencies employ a three step methodology to assess whether committed entry would deter or counteract a competitive effect of concern.

40. The first step assesses whether entry can achieve significant market impact within a timely period. If significant market impact would require a longer period, entry will not deter or counteract the competitive effect of concern.

41. The second step assesses whether committed entry would be a profitable and, hence, a likely response to a merger having competitive effects of concern. Firms considering entry that requires significant sunk costs must evaluate the profitability of the entry on the basis of long term participation in the market, because the underlying assets will be committed to the market until they are economically depreciated. Entry that is sufficient to counteract the competitive effects of concern will cause prices to fall to their premerger levels or lower. Thus, the profitability of such committed entry must be determined on the basis of premerger market prices over the long-term.

42. A merger having anticompetitive effects can attract committed entry, profitable at premerger prices, that would not have occurred premerger at these same prices. But following the merger, the reduction in industry output and increase in prices associated with the competitive effect of concern may allow the same entry to occur without driving market prices below premerger levels. After a merger that results in decreased output and increased prices, the likely sales opportunities available to entrants at premerger prices will be larger than they were premerger, larger by the output reduction caused by the merger. If entry could be profitable at premerger prices without exceeding the likely sales opportunities -- opportunities that include pre-existing pertinent factors as well as the merger-induced output reduction -- then such entry is likely in response to the merger.

43. The third step assesses whether timely and likely entry would be sufficient to return market prices to their premerger levels. This end may be accomplished either through multiple entry or individual entry at a sufficient scale. Entry may not be sufficient, even though timely and likely, where the constraints on availability of essential assets, due to incumbent control, make it impossible for entry profitably to achieve the necessary level of sales. Also, the character and scope of entrants' products might not be fully responsive to the localised sales opportunities created by the removal of direct competition among sellers of differentiated products. In assessing whether entry will be timely, likely, and sufficient, the agencies recognise that precise and detailed information may be difficult or impossible to obtain. In such instances, the agencies will rely on all available evidence bearing on whether entry will satisfy the conditions of timeliness, likelihood, and sufficiency.

### *7.4 Efficiencies Analysis*

> "Fourth, the agencies assess any efficiency gains that reasonably cannot be achieved by the parties through other means."

44. The analytical steps involved in efficiencies analysis are described as follows:

45. Competition usually spurs firms to achieve efficiencies internally. Nevertheless, mergers have the potential to generate significant efficiencies by permitting a better utilisation of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction. Indeed, the primary benefit of mergers to the economy is their potential to generate such efficiencies.

46. Efficiencies generated through merger can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products. For example, merger-generated efficiencies may enhance competition by permitting two ineffective (*e.g.*, high cost) competitors to become one effective (*e.g.*, lower cost) competitor. In a co-ordinated interaction context, marginal cost reductions may make co-ordination less likely or effective by enhancing the incentive of a maverick to lower price or by creating a new maverick firm. In a unilateral effect context, marginal cost reductions may reduce the merged firm's incentive to elevate price. Efficiencies also may result in benefits in the form of new or improved products, and efficiencies may result in benefits even when price is not immediately and directly affected. Even when efficiencies generated through merger enhance a firm's ability to compete, however, a merger may have other effects that may lessen competition and ultimately may make the merger anticompetitive.

47. The agencies will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed *merger-specific efficiencies*. Only alternatives that are practical in the business situation faced by the merging firms will be considered in

making this determination; the agencies will not insist upon a less restrictive alternative that is merely theoretical.

48. Efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms. Moreover, efficiencies projected reasonably and in good faith by the merging firms may not be realised. Therefore, the merging firms must substantiate efficiency claims so that the agencies can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific. Efficiency claims will not be considered if they are vague or speculative or otherwise cannot be verified by reasonable means.

49. *Cognisable efficiencies* are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service. Cognisable efficiencies are assessed net of costs produced by the merger or incurred in achieving those efficiencies.

50. The agencies will not challenge a merger if cognisable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market. To make the requisite determination, the agencies consider whether cognisable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, *e.g.*, by preventing price increases in that market. In conducting this analysis, the agencies will not simply compare the magnitude of the cognisable efficiencies with the magnitude of the likely harm to competition absent the efficiencies. The greater the potential adverse competitive effect of a merger—as indicated by the increase in the HHI and post-merger HHI, the analysis of potential adverse competitive effects, and the timeliness, likelihood, and sufficiency of entry—the greater must be cognisable efficiencies in order for the agencies to conclude that the merger will not have an anticompetitive effect in the relevant market. When the potential adverse competitive effect of a merger is likely to be particularly large, extraordinarily great cognisable efficiencies would be necessary to prevent the merger from being anticompetitive.

51. In the agencies' experience, efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are not great. Efficiencies almost never justify a merger to monopoly or near-monopoly.

52. The agencies have found that certain types of efficiencies are more likely to be cognisable and substantial than others. For example, efficiencies resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the marginal cost of production, are more likely to be susceptible to verification, merger-specific, and substantial, and are less likely to result from anticompetitive reductions in output. Other efficiencies, such as those relating to research and development, are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions. Yet others, such as those relating to procurement, management, or capital cost are less likely to be merger-specific or substantial, or may not be cognisable for other reasons.

### *7.5 Failing Firm Analysis*

> "Finally the agencies assess whether, but for the merger, either party to the transaction would be likely to fail, causing its assets to exit the market."

53. The analytical steps involved in failing firm analysis are described as follows:

54. A merger is not likely to create or enhance market power or facilitate its exercise if the following circumstances are met:

a) the allegedly failing firm would be unable to meet its financial obligations in the near future;

b) it would not be able to reorganise successfully under Chapter 11 of the Bankruptcy Act;

c) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisition of the assets of the failing firm that would both keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger; and

d) absent the acquisition, the assets of the failing firm would exit the relevant market.

## 8. Other Public Interest Considerations in Merger Review

55. The United States antitrust agencies do not employ a "public interest" test in analysing mergers. "The unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise . . .. While challenging competitively harmful mergers, the Agenc[ies] seek[] to avoid unnecessary interference with the larger universe of mergers that are either competitively beneficial or neutral." GUIDELINES 0.1

56. For many years, a United States regulatory agency for the airline industry applied a public interest test in the specific case of mergers in the airline industry. After forty years of experience with that test, it was generally not viewed as useful or necessary, and the separate test was eliminated when the airline industry was deregulated. Since 1989, mergers in the industry have been governed by the ordinary application of the antitrust laws. *See* Civil Aeronautics Board Sunset Act, 49 U.S.C. § 1551(a)(7).

57. Certain regulatory agencies still employ a public interest test in reviewing mergers under other non-antitrust statutes. The Federal Communications Commission (FCC), for example, reviews mergers in the telecommunications industry through its power to approve transfers of licenses, an employs a statutory public interest standard. In reviewing mergers involving the former Bell Operating Companies, for example, the FCC in its 1997 ruling in the SBC/Pacific Telesis merger applied a competition standard requiring that "no foreseeable adverse consequences [to competition] will result." Later that year, however, in the Bell Atlantic/NYNEX merger, the FCC, noting that its decision was "informed by antitrust principles" but "not limited by the antitrust laws," applied a standard requiring that the merger "on balance will enhance and promote, rather than eliminate and retard, competition."

58. In the case of railroads, jurisdiction over mergers resides solely in the Surface Transportation Board (STB), which applies a "public interest" standard that takes into account such factors as public benefits, labour conditions, environmental issues, and effects on competition. The DOJ provides non-binding advice to the STB, which must consider, but need not heed, the DOJ's recommendations. In the 1996 Union Pacific/Southern Pacific merger, which involved the combination of two of only three major railroads in the Western United States, the DOJ recommended denying the merger application. The DOJ concluded that the transaction would significantly reduce competition in numerous markets where the number of carriers dropped from two to one or from three to two, and that the remedy proposed by the carriers (granting trackage rights to the third western railroad) was unworkable and insufficient. The DOJ also found that the efficiencies claimed did not outweigh the competitive harms. The STB did not accept DOJ's recommendation, instead giving great weight to the benefits claimed by the carriers. The STP found that trackage rights were sufficient to replace direct competition where the number of carriers fell

from two to one, and that a reduction from three competitors to two was not of concern. Following implementation of the merger, there was a massive service breakdown in the West, resulting in billions of dollars in losses to shippers. In addition, there were numerous complaints that the trackage rights have been ineffective in replacing competition lost because of the merger.

59. In 2001 the STB established new procedures for review of major rail consolidations that stated the agency would look to antitrust standards in reviewing the competitive effects of mergers and would "take a more skeptical 'show me' attitude toward claims of merger benefits and toward claims that no transitional service problems would occur." Major Rail Consolidation Procedures, Ex Parte No. 582 (Sub-No. 1)(June 11, 2001).

## 9. Conclusion

60. Over the last half century, United States merger analysis has become increasingly well grounded in economics and it has become more clearly focused solely on protection of consumer welfare. Older views have been rejected as misguided: *e.g.*, seeking protection of competitors, rather than competition; any assumption that there is something inherently undesirable about large firms, including conglomerate firms; restriction of even small increases in market concentration in the absence of evidence of anticompetitive harm; "populist" attempts to preserve a large number of firms merely for the sake of numbers, even though such preservation was unnecessary for effective and efficient competition. Today, United States merger analysis is focused squarely on "whether the merger is likely to create or enhance market power or to facilitate its exercise." GUIDELINES 0.2