Overhauled Horizontal Merger Guidelines: Operating Within the New Antitrust Framework
Preparing for Heightened FTC and DOJ Review and Data Requirements

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today’s panel features:
Michael H. Byowitz, Partner, Wachtell, Lipton, Rosen & Katz, New York
Gregory Vistnes, Vice President, Charles River Associates, Washington, D.C.

Thursday, October 14, 2010
The conference begins at:
1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

You can access the audio portion of the conference on the telephone or by using your computer’s speakers. Please refer to the dial in/ log in instructions emailed to registrants.
For CLE purposes, please let us know how many people are listening at your location by

- closing the notification box
- and typing in the chat box your company name and the number of attendees.
- Then click the blue icon beside the box to send.

For live event only.
• If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

• If the sound quality is not satisfactory and you are listening via your computer speakers, please dial **1-866-258-2056** and enter your PIN when prompted. Otherwise, please send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.

• If you dialed in and have any difficulties during the call, press *0 for assistance.
Overhauled Horizontal Merger Guidelines: Operating Within the New Antitrust Framework

Strafford Webinar
October 14, 2010

Anthony Swisher
Akin Gump Strauss Hauer & Feld LLP
aswisher@akingump.com
202-887-4263
Today’s Agenda

- Brief Merger Guidelines History – Anthony Swisher
- Key Provisions in the New Guidelines – Michael Byowitz
- Focus on Economic Analysis: Theory and Data – Greg Vistnes
- Implications - Panel
  - Merger Analysis and Investigation
  - Merger Litigation
  - Strategies for Firms Contemplating Mergers
- Questions
History of the Horizontal Merger Guidelines

- **1968: DOJ Guidelines**
  - Thresholds of: 15% + 1%, 10% + 2%, 4% + 4%, etc.
  - Hypothesis: increasing concentration = higher prices

- **1982 (revised 1984): DOJ Guidelines**
  - Herfindahl-Hirschman Index (HHI) and “safe harbors”
  - Almost exclusively focused on coordinated effects, but...
  - “Leading firm proviso” of 35%
History of the Horizontal Merger Guidelines

  - Five-step framework
    1. Market Definition, Measurement, and Concentration
    2. Competitive Effects
    3. Entry Barriers
    4. Efficiencies
    5. Other Defenses (e.g., failing company)
  - Focus on both coordinated and unilateral potential effects
  - Retained 35% unilateral effects threshold
2010: Why another revision?

- Obama Administration
  - “As president, I will direct my administration to reinvigorate antitrust enforcement.”

- Transparency
  - Closing “[g]aps between what the Agencies say we do and what we actually do.” – AAG Christine Varney, Antitrust Division

- Evolving Economic Theory
  - “[T]he black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics.” – Oliver Wendell Holmes

- Litigation Losses
History of These Guidelines

- Public “ideas” workshops
- Draft for public comment – April 2010
- Final Guidelines – August 19, 2010
- Key Comments by Agencies
  - “[T]he Guidelines emphasize the competitive effects of a deal over the more rigid, formulaic approach imposed by some interpretations of the 1992 Guidelines.” – FTC Chairman Leibowitz
  - “The revised Guidelines better reflect the Agencies’ actual practices. [They] provide more clarity and transparency, and will provide businesses with an even greater understanding of how we review transactions.” – AAG Varney, Antitrust Division
Commissioner Rosch’s Concurrence/Critique

- “[O]f the six architects of the project, three were economists trained and steeped in price theory...This process inevitably led to overemphasis on economic formulae and models based on price theory.”

- “[I]t would be wrong not to acknowledge that these Guidelines are still flawed both as a description of how the staff...conducts ex ante merger review and what the Agencies should tell courts about merger analysis.”

- “This process cannot be justified on the ground that the Guidelines are supposed to be transparent...These Guidelines do not describe the way that...staff at the Commission proceed today. They also do not reflect the way that the courts proceed.”
Basic Approach of New Guidelines

 “These Guidelines describe the principal analytical techniques and the main types of evidence on which the Agencies usually rely.”

 Five Key Types of Evidence:
  – “Actual effects observed in consummated mergers”
  – “Direct comparisons based on experience”
  – “Market shares and concentration in a relevant market”
  – “Substantial head-to-head competition”
  – “Disruptive role of a merging party”

 NOTE: relevant market only one of several factors

 The Agencies “need not rely on market definition or the calculation of market shares and concentration.” (§ 6.1)
Theories of Antitrust Harm

- Unilateral Effects
  “A merger can enhance market power simply by eliminating competition between the merging parties...even if the merger causes no changes in the way other firms behave.”

- Coordinated Effects
  “A merger can also enhance market power by increasing the risk of coordinated, accommodating, or interdependent behavior among rivals.”
What happened to the old threshold numbers?

- Unilateral effects threshold
  - **Old:**
    - 35% combined share
  - **New:**
    - gone

- Time thresholds for “crediting” new entry
  - **Old:**
    - Diversion of existing assets: within 1 yr
    - Greenfields entry: within 2 yrs
  - **New:**
    - “rapid enough”
What happened to the old threshold numbers?

- HHI Safe Harbors and Presumptions

<table>
<thead>
<tr>
<th></th>
<th>OLD</th>
<th>NEW</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HHI</td>
<td>Δ</td>
</tr>
<tr>
<td>Unconcentrated</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt;1000</td>
<td>any</td>
<td>ordinarily ok</td>
</tr>
<tr>
<td>1000-1800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt;100</td>
<td></td>
<td>potential problem</td>
</tr>
<tr>
<td>&gt;1800</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Moderately</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Concentrated</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Highly</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Concentrated</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Key Provisions of the New Merger Guidelines

Michael H. Byowitz and Daniel E. Hemli
Wachtell, Lipton, Rosen & Katz

Michael H. Byowitz
212.403.1268
MHBByowitz@wlrk.com

October 14, 2010
Overall Reaction to New Guidelines

● New Guidelines purport to accurately reflect current approach to horizontal mergers
  – Do in many respects
  – But not in heavy reliance on economic models

● Seek to provide more transparency but abandon specificity in number of respects
  – Analysis is more flexible than reflected in ‘92 Guidelines
  – “Grab bag” quality to new Guidelines
  – Big change from ‘92 but often consistent with longtime trend at agencies

● Conscious attempt to move courts away from ‘92 Guidelines standards and case law
What’s New/Different

● ‘92 Guidelines used market definition and concentration as a screen
  – If above specified levels:
    » Further investigation might be warranted but
    » Guidelines not predictive: Challenges unlikely at levels indicated (in most industries)
  – If below specified levels, no further investigation

● New Guidelines use market definition/concentration as one of many factors
  – Under new Guidelines, no fixed order of analysis
  – Not all analytical tools applied in every case
  – No longer using market definition/concentration as a screen?
    » More scope for investigations/divestitures
    » Can have broad markets but anticompetitive effect because particularly close substitutes?
What’s New/Different (cont.)

● More use of economic tests
  – More detail on hypothetical monopolist test
  – New discussion of critical loss analysis

● Expanded and significantly revised discussion of unilateral effects
  – Elimination of 35% threshold
  – Extensive use of analyses other than traditional market definition/concentration
    » Diversion rations and UPP/GUPPI
    » Negative inference from high margins
  – Heightened focus on potential harm to innovation

● Entry: Elimination of time periods

● New sections on
  – Powerful buyers
  – Monopsony issues
  – Partial acquisitions
Types and Sources of Evidence

Types of Evidence:
● Market shares and concentration just one of several factors (see initial presentation)

Sources of Evidence:
● Merger parties = key source of evidence: documents, data, what business people say
● Customers
  – Most merger investigations involve intermediate products
  – Customers have mixed motives in complaining about deals
    » Where customers’ views diverge, look to whether complainers differently situated (than supporters and neutrals) and hence more likely to be harmed
    » Silent on similarly situated customers with divergent views: Sophisticated customers critical in litigated mergers. Compare Oracle/PeopleSoft with Drug Wholesalers
● Competitors
  – Rivals’ interests often diverge from customers (complaints about pro-competitive deals)
  – Competitors nonetheless considered useful source of information
Reduced Emphasis on Market Definition/Concentration

● Market definition not an end in itself; useful if illuminates likely competitive effects

● Market definition helps specify “line of commerce” and “section of the country” in which competitive concern arises
  – Language taken directly from Clayton Act § 7; not in April Guidelines draft
  – Per n.2, agencies will not necessarily dispense with any analytic element in merger challenge (Shapiro: DOJ will identify relevant markets when litigating)

● Market definition only one among many tools
  – Not necessarily undertaken as threshold matter
  – Not always undertaken during investigation (particularly in unilateral effects)

● Reduced emphasis on market definition/concentration = very significant change?
  – Does this mean more investigations and divestitures?

● Inconsistent with case law: How will this play out in courts?
Revised Hypothetical Monopolist Test

- Focus on whether profitable to increase price on one (as opposed to all) products of merging firms
  - Basis for narrowing markets
- Noteworthy detail regarding SSNIP
  - Makes clear that SSNIP is not a price increase tolerance test
  - Most often use 5% but not always
  - Flexibility as to what to apply SSNIP to
    » Focus on fees where that is how competitors are compensated for services
    » Compute implicit price in difference between purchased and sold price, where applicable
- Concern about higher margins reflecting price insensitivity
  - In past, high margins considered helpful to merger parties (in critical loss analysis)
Price Discrimination Receives Increased Focus

- Separate section (largely reflects current agency practice)

- Recognized in ‘92 Guidelines (and earlier)

- More detail on how to apply

- Two conditions for price discrimination to be feasible
  - Differential pricing possible
  - Opportunities for arbitrage limited

- Example 11: *But see* FTC’s loss in Owens-Illinois/Brockway

- Price discrimination = one of several ways to define narrow markets
Narrow Market Definition Preferred

- Several bases for defining narrow markets
  - Price discrimination
  - Differentiated products and next closest substitutes

- Strong preference for narrow markets
  - “[A] group of products is too narrow to constitute a relevant market if competition from products outside that group is so ample that even the complete elimination of competition within the group would not significantly harm either direct customers or downstream consumers.” (Section 4, emphasis added)
  - Meant to connote a change from ‘92?
  - “Profitable” vs. “so ample”

- Narrow markets won’t always fly with the courts
  - Whole Foods/Wild Oats – FTC successful
  - District courts in Whole Foods and Oracle/PeopleSoft – agencies unsuccessful
Expanded Discussion of Unilateral Effects

- Continued focus on differentiated products and next best substitutes
- No 35% combined market share threshold for presuming merging firms are significant direct competitors
- Significant reliance on diversion ratios and value of diverted sales (UPP/GUPPI)
  - More reliance than on HHIs
  - Less emphasis on diversion to non-merging competitors
  - Concern that models may be biased because always show some price increase
  - Are efficiencies, repositioning and ease of entry enough to overcome?
    » Agencies dubious re efficiencies
    » Treat repositioning as a form of entry; Shapiro says it normally isn’t sufficient
- Concern about high margins
  - Where exist, it may be sufficient to find a competitive problem to show a minority of customers view merger parties’ products as next-best substitutes
Expanded Discussion of Unilateral Effects (cont.)

● New section on bargaining and auctions
  - Focus on unilateral effects extends to homogeneous products where bidding market
  - Win-loss and other bidding data critical in auction markets, if available
  - Agencies/parties frequently have relied on such evidence in “bidding” markets in past

● New section on innovation and product variety
  - Focus on potential harm to innovation competition
    » Minimal discussion of potential benefits
  - Pfizer/Wyeth = recent example
    » FTC devoted attention to potential “pure” innovation concerns in human health with no connection to price effects
    » Ultimately found merger would not affect competition in basic pharmaceutical R&D
Entry

- Rapid [previously “uncommitted”] entrants:
  - Removed one year time frame for supply response
  - Analyzed as market participants, often assigned market shares (where able to predict)

- Other [previously “committed”] entrants:
  - Elimination of some language from ‘92 Guidelines on requirements for committed entrants
    » e.g., removed explicit reference to minimum viable scale
  - Absence of prior entry following increases in profit margins means entry is slow or difficult
  - Market values of incumbent firms much > replacement cost of their tangible assets may indicate valuable intangible assets, making entry difficult or time consuming
  - Removed two-year timeframe for timeliness
Efficiencies, Powerful Buyers

- **Efficiencies**
  - Similar to ‘92/97: Burden on efficiencies proponents
    - Efficiencies must be merger specific and cognizable
  - Agencies even more dubious of efficiency claims than new Guidelines indicate
  - Consistent with ‘92/97 as to bottom line
    - Efficiencies only likely to change result in marginal case
    - *i.e.*, may change outcome only where merger parties may win without them

- **Powerful buyers**
  - Seek to make proving this mitigating factor more rigorous
  - Existence alone not sufficient
    - Need to show capable of constraining ability of merged firm to raise prices
  - Even powerful buyers can be harmed by anticompetitive mergers
    - Reduce ability to negotiate lower price
    - Also Drug Wholesalers/Oracle-PeopleSoft type of harm
  - Cannot ignore smaller buyers (price discrimination)
Monopsony Issues, Partial Acquisitions, Failing Firms

**Monopsony issues**
- Recognize that mergers can produce pro-competitive buyer-side efficiencies
- No analytic framework provided to distinguish between mergers creating monopsony power and those producing such efficiencies
- Abandon more traditional notion that need a downstream effect for there to be a competitive concern (explicit concern about wealth transfers)

**Partial acquisitions analysis**
- No significant change from what agencies have been doing in recent years
- Useful to have standards laid out in Guidelines

**Failing firm defense**
- No relaxation
- Agencies believe mission of preserving competition even more important in difficult economic times
Citations


An Economist’s View of the New Merger Guidelines

From Betty Crocker to Julia Child

Gregory S. Vistnes
Charles River Associates
Washington, DC

202-662-3859
gvistnes@crai.com
Overview

• The Motivations For Change
• Effects Of The Change
• What Part Of “No” Don’t You Understand?
  – Critical Loss
  – Buyer Power
• And While We’re At It ....
  – Monopsony
  – Partial Acquisitions
• What Are The Implications?
Motivations for Change

• Clarification Of Existing Agency Practices

• Clarification Regarding Misunderstood/Misused Economic Analyses
  – Critical Loss analyses
  – Buyer Power arguments
  – The role of market definition

• Concern That These Problems Were Reducing Agencies' Ability To Show Anticompetitive Effects
  – Yes, this means increasing the Agencies' ability to block mergers
Motivations for Change

Market Definition

• Market Definition Was Proving Problematic
  – A useful concept getting out of control
  – Difficult to operationalize in unilateral effects cases
    • Suggested markets that many found “overly narrow”
    • Suggestion that all UE cases involve “merger to monopoly”
  – Concerns that the tail was wagging the dog
    • Market Definition dominating Competitive Effects Analysis?

• What Role For Market Definition?
  – Identification of key players?
  – Substitute for competitive effects?

• Can Unilateral Effects Coexist With Broadly Defined Markets?
Motivations for Change

Clarification of Existing Economic Concepts

• 1992 HMG May Have Oversimplified When Unilateral Effects Might Arise
  – 1992 HMG identified when UE may be most likely
    • 35% market share
    • Next Best Substitutes
  – New HMG clarify that UE can also arise in other situations

• New HMG Clarify That Margins Are Also Important in UE Analyses
The Consequence of the Changes

*Evolution, Not Creation*

- The New HMG Retain The Same Basic DNA
  - Basic unilateral and coordinated effects concerns remain the same

- Effort To Shed Useless Tails, But Grow Oppposable Thumbs
  - Shedding ideas that didn’t help (and may have hurt)
    - 35% criteria for Unilateral Effects
    - Suggested importance of “next best substitutes”
  - More discussion of “competitive constraints”
  - Attempt to let UE co-exist with more broadly defined, and more intuitively plausible, markets
The Evolving HMG

• HMG Place Less Emphasis On Market Definition
  – “The measurement of market shares and market concentration is not an end in itself, but is useful to the extent it illuminates the merger’s likely competitive effects” [HMG at 4.0, emphasis added]

• UE And Broadly Defined Markets Can Co-exist
  – Not all rivals within a market are equal
    • Expanding the market to include less competitively significant rivals is not problematic if this point is recognized
  – UE can still arise in broadly defined markets with many rivals if the merging rivals are important competitive constraints to each other.

• Courts’ Willingness To De-emphasize Market Definition Is Less Clear
The Evolving Competitive Effects Analysis

• New HMG Emphasize The Importance Of Diversion And Margins
  – This is not a new economic idea
    • See, for example, Shapiro (Antitrust Magazine, 1996)
  – Key concept: Does a merger allow for significant "recapture" of lost profits following a price increase?
    • Recaptured profits depend on the number of recaptured sales as measured by the Diversion Ratio
    • Recaptured profits depend on the margins

• UPP And GUPPI: A Rose By Any Other Name
  – Not so different than what we’ve seen in the past
    • See, for example, Salop and Moresi (2010)
  – Impact on Agency practices is unclear
Moving from Rules to Flexibility

*Julia Child replaces Betty Crocker*

- Previous HMG Suggested Rule-Driven Approach
- Failure to Always Practice What They Preached
  - HHI Safe Harbors
  - 35% requirement for UE
  - Implication that UE typically means 2-Firm Markets
- Rules Vs. Discretion: Trading Simplicity For Accuracy
  - Sacrificing clarity in 95% of mergers because of problems with the remaining 5% of mergers?
  - Sacrificing “false clarity” may be a good thing
Just Say “No”

Critical Loss (CL) Analyses

- CL Involves a Comparison
  - What level of sales would have to be lost to make a price increase unprofitable (the hurdle)?
  - What level of sales would likely be lost?
  - Are likely lost sales more/less than the hurdle?

- Margins Affect Both Sides Of The Comparison
  - Many "Critical Loss" analyses focus just on establishing that high margins create a low hurdle
  - High margins also reduce the likelihood of overcoming that hurdle
Just Say “No”

*Buyer Power (BP) Arguments*

- Agencies Recognize The Legitimacy Of BP Arguments In Some Contexts
  - Defeating a cartel
  - Sponsoring entry

- Agencies Reject The Argument That Big Buyers Are Immune To Increased Supplier Bargaining Power
  - While buyer power may help achieve an initially low price, it doesn’t necessarily protect against a post-merger price increase
While We’re At It ....

- Identification Of Two Concepts That Received Little Or No Attention In The 1992 HMG
  - Monopsony
  - Partial Acquisitions

- New HMG Largely State Existing Practice With Respect To Monopsony And Partial Acquisitions

- Entry
  - Retains notion of "timely, likely and sufficient"
  - No more use of two year window to define timeliness
Implications of the New Merger Guidelines

Akin Gump Strauss Hauer & Feld LLP
Charles River Associates
Wachtell, Lipton, Rosen & Katz

October 14, 2010
Implications for Merger Analysis and Investigation

● Greater agency flexibility
  – New Guidelines provide roadmap as to evidence necessary and interpretation of evidence
  – Relatively less reliance on market definition and concentration
  – Change in concentration numbers welcome but overstated (number of rivals that matter)

● How much more significant will economists be in agency decision making?
  – More extensive data demands?

● May mean continuing trend to more extensive/longer investigations including more Second Requests
  – Particularly from focus on data
  – Puts more pressure on the initial HSR waiting period
Implications for Merger Analysis and Investigation (cont.)

- May mean increased demands for divestitures
  - Focus on both price and non-price elements of competition
  - More tools for finding problems

- Better results for merger parties may be achievable with credible litigation threat (e.g., Whirlpool/Maytag)
  - Agencies trying to vitiate/reduce ability of parties to prevail in litigation (thereby reducing threat)
  - Fact agencies may litigate differently than analyze in investigation underscores agency concern about potential litigation losses
  - Unclear how new Guidelines will fare in court
Implications for Merger Litigation

- Tone suggests certainty in predicting which mergers create/enhance market power
  - But wider range of factors need to consider in making predictions
  - Several references to agency extensive experience
  - Reality = great deal of speculation involved
  - New Guidelines rely on incipiency standard, ignoring language from case law about requiring “probabilities” rather than “ephemeral possibilities”

- Conscious effort to influence courts
  - Unclear how courts to react to diminished role of market definition/move from five-step approach
  - New Guidelines very strongly tilted towards reliance on economics
    » Diversion ratios trump HHIs in differentiated products analysis (6.1)
    » Merger simulations need not rely on market definition (id.)
Implications for Merger Litigation (cont.)

- Courts historically not comfortable with economic and econometric evidence
  - New Guidelines’ increased emphasis on these may not be received enthusiastically
  - New Guidelines can be viewed as attempt by agencies to clarify how to use/interpret economics
    - By clarifying use and misuse of economics, agencies seeking to reduce tension courts currently believe exists between economics and other evidence

- Litigated challenges mostly 3-2 cases
  - Baby Food: *FTC v. H.J. Heinz Co.*, 246 F.3d 708 (D.C. Cir. 2001)
Strategies for Firms Contemplating Mergers

● Need to perform antitrust analysis as early as possible

● More (and potentially more complex) analysis upfront for some deals to marshall relevant facts and evidence, before filing HSR (where feasible)
  – Agencies’ focus on data-driven analyses, even at early stages, emphasizes importance of collecting data early in merger process
  – In many cases, data likely to be sought prior to Second Request can be anticipated, and prepared prior to the HSR filing

● Need to retain economists earlier in process for potentially problematic deals
  – UPP test may lead to investigation of transactions that otherwise would not raise issue
  – Also important where there is a chance of avoiding a Second Request

● Need to incorporate potential for longer antitrust reviews into overall deal timelines (or adopt effective strategies to move review along)