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Merger Analysis

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Topics

- General Statutes – Incipiency Standard
- Horizontal Mergers
- Vertical Mergers
- Merger Remedies
- Hart-Scott-Rodino Act Forms and Rules
- Gun Jumping

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Statutes and Guidance – Section 7

Section 7 of The Clayton Act,
15 U.S.C. § 18

An Incipiency Standard
Requiring Prediction of the Future

An acquisition is prohibited if "the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly

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Statutes and Guidance – Section 7

(con't)

Section 7 Incipiency Standard:

- Certainty of anticompetitive harm is not required.
  FTC v. Arch Coal, 329 F. Supp. 2d at 115.
- "[R]easonably likely to cause anticompetitive effects."
  U.S. v. Oracle Corp., 331 F. Supp. 2d at 1109.
- "[P]robabilities, not ephemeral possibilities"
  FTC v. Whole Foods, 502 F. Supp. 2d 1
  (D.D.C. 2007) (quoting Arch Coal).

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Horizontal Mergers

Horizontal Mergers — Overview

Goal of the Analysis – To Answer the Questions:

- Is the merger likely to create or enhance market power?
- Put differently, is the merger likely to result in higher prices, reduced output, lower quality or reduced innovation?

Framework for Analysis Is Set Forth In

- Joint DOJ and FTC Horizontal Merger Guidelines
  (August 19, 2010)
- Case law
- Speeches and articles

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Primary Goal: Competitive Effects

Two Broad Analytical Frameworks for Competitive Effects Analysis in both Horizontal Merger Guidelines and in court cases

- Unilateral Effects
- Coordinated Interaction

Other elements of merger analysis play a supporting, albeit important, role in evaluating potential competitive impact of a merger

- Market Definition and Market Participants
- Market Shares and Concentration
- Entry Analysis
- Efficiencies

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Competitive Effects – Unilateral

Unilateral Effects

- Tendency of the merger to result in higher prices or reduced output or innovation by virtue of elimination of competition between the merging firms – even though other firms continue to compete independently
- Merger creates an incentive to raise prices or reduce output that would not have existed in the absence of the merger

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Competitive Effects – Unilateral

(con't)

Scenarios

- Merger to monopoly
- Differentiated Products: Merger of two close competitors in differentiated product business where merger creates incentive to raise prices on one of the merging products because significant lost sales will be "recaptured" by the other merging products

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Competitive Effects – Unilateral

(con't)

Scenarios (con't)

- Capacity Constrained Industry: Merger would create a large firm that can raise prices without risking output responses from other capacity constrained competitors
- Markets Characterized by Auctions/Bidding
  - Merger would reduce number of bidders below a critical level
  - Merger would combine the two lowest cost bidders, permitting prices to rise to the cost level of the next lowest cost bidder
  - Merger combines two bidders with strongest reputation or other characteristics that make other bidders less than equal alternatives

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Competitive Effects – Unilateral

(con't)

Scenarios (con't)

- Markets Characterized by Bargaining
  - Merger involves two firms that buyers were most able to play off one another
  - Merging two firms with the clearest history of giving pricing concessions to win bids; enables merging firms to eliminate discounting

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Competitive Effects – Unilateral

(con't)

Scenarios (con't)

- Unilateral Curtailment of Innovation
  - Most likely to occur where one merging firm is innovating in ways that would take substantial revenues from the other merging firm
  - Consider whether incentives to innovate will change
  - No definition of a test, but a benefit-cost style analysis is the likely approach

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Competitive Effects – Unilateral

(con't)

- Quantitative Tools for Analyzing Differentiated Product Mergers
  - The 2010 Guidelines identify the quantitative analytical tools that the Agencies use, in addition to qualitative evidence (e.g. win/loss data) to evaluate these mergers:
    - Diversion Ratio – the fraction of unit sales lost to another product from a product whose price has been increased.
      - Higher ratios suggest a greater likelihood of price increases
    - UPP (Upward Pricing Pressure) – measures the value of sales diverted from one merging product to the other and tests whether the merger changes the incentive to raise prices
      - Also can be viewed as an indication of the degree to which one firm constrains the other on pricing.
    - Merger Simulations – complex econometric models designed to predict price increases

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Competitive Effects – Unilateral

(con't)

- The 2010 Guidelines provide some analytical conclusions from and about these tools:
  - Unilateral price effects are predicted as likely even though the diversion ratio between the merging products is well under 50% and when substantially more sales are diverted to products not involved in the merger
  - Diversion ratios between the merging products and non-merging products have "at most secondary predictive value"
  - The guidelines say the Agencies rely more on the value of diverted sales (UPP) than on HHI levels in analyzing differentiated product mergers
  - Merger simulation results are not conclusive, but are given more weight if they consistently predict substantial price increases in various formulations

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Competitive Effects–Upward Pricing Pressure

- Relatively new articulation of a long established concept: merging two differentiated products that are close substitutes can result in price increases
  - merger increases the incentive to raise the price of one of the products because a significant portion of the sales lost as a result of the price increase will be internalized post merger
  - merger decreases the incentive to reduce prices on one of the products because such a reduction will cannibalize the now-owned closest substitute
- Viewed as an alternative to market definition and concentration analysis for differentiated products
- Analyzes post-merger changes in pricing incentives
- Only indicates an increase in the incentive to raise prices, not the magnitude of any predicted price increases

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Competitive Effects–Upward Pricing Pressure

(con't)

- 2010 Guidelines and related literature on Upward Pricing Pressure have led to the development of GUPPI
- GUPPI = Gross Upward Pricing Pressure Index
- Examples of this Literature are:
  - Joseph Farrell and Carl Shapiro, "Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition," The B.E. Journal of Theoretical Economics, Vol. 10, Issue 1, Article 9 (2010).
  - Steven C. Salop and Serge Moresi, "Updating the Merger Guidelines: Comments (November 9, 2009), available at http://www.ftc.gov/os/comments/horizontalmergerguides/ 545095-00032.pdf.

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Competitive Effects–Upward Pricing Pressure

(con't)

- GUPPI for Product 1 = $\frac{\text{value of sales volume diverted to Product 2}}{\text{value of sales volume lost by Product 1}}$

$$= \frac{\text{number of units diverted to Product 2 x unit margin of Product 2}}{\text{number of units lost by Product 1 x unit price of Product 1}}$$

- Simple version:
  - $GUPPI_1 = DR_{12} \times M_2 \times P_2/P_1$
    - DR_{12} = Ratio of Diversion from Product 1 to Product 2
    - M_2 = Percentage Profit Margin for Product 2
    - P = Price for each of the respective products

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Competitive Effects–Upward Pricing Pressure

(con't)

- GUPPI of 5% or less will be considered small and of no concern
- Because GUPPI is a measure of changes in incentives, a 5% change in the pressure or incentive to increase prices is thought unlikely to result in an actual price increase
- Example of recent use: The FCC's Economic Analysis of AT&T's proposed acquisition of T-Mobile has a detailed written GUPPI analysis that concludes that GUPPI exceeded 5% and that the merger would greatly affect incentives.

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Competitive Effects – Unilateral

- Unilateral Effect – Examples
  - Ecolab, Inc. – Permian Mud
    - Merging two of only three providers of production chemical management services for oil and gas wells drilled in over 1000 feet of water ("Deepwater PCMS") in the Gulf of Mexico
    - The combined company would control 70% of the market
    - Frequently, one another's second choice in the view of customers
    - Were head-to-head competitors on most opportunities in the Gulf
    - Evidence that their competition had spurred one another to develop and improve products, performance and technology that had benefited customers
    - Due to the need for reputation and many years of experience, entry was difficult
    - DOJ concluded that post-merger, Ecolab would gain both the incentive and ability to raise its bid prices and to reduce R&D

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Competitive Effects – Unilateral

(con't)

- Tyson Foods Inc. – Hillshire Brands Company
  - Combining two sausage manufacturers and two major purchasers of sows
  - 35% of all sow purchases combined
  - No use for sows other than making sausage, so decrease in price would not cause substitution
  - Merging parties are two best alternatives for many farmers
  - Post-merger bidding is likely to be less aggressive with fewer bidders and result in lower prices
  - Entry not timely due to challenges in finding buying station locations
  - DOJ concluded divestiture of a sow purchasing and re-selling entity was required

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Competitive Effects – Unilateral

(con't)

- AB InBev – Modelo
  - merging AB InBev, the largest U.S. beer brewer with 39% of all U.S. beer sales (and larger shares in some metropolitan areas), with Modelo, the third largest brewer with a 7% national share and local shares as high as 20%
  - DOJ concluded that a significant number of consumers view AB InBev's brands and Modelo's brands as substitutes
  - DOJ concluded the merger would create the incentive for AB InBev to raise prices on some brands and recapture sales as consumers shift between AB InBev and Modelo brands
  - DOJ found that Modelo had significantly limited AB InBev's past ability to raise prices and that the second largest brewer, MillerCoors, did not do so as a result of tacit coordination

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Competitive Effects – Unilateral

(con't)

- Grupo Bimbo – Sara Lee
  - sliced bread production and delivery in various local markets
  - combining the first and third largest producers in the U.S.
  - many Grupo Bimbo and Sara Lee sliced bread products were close substitutes for one another (although not necessarily one another's closest substitutes)
  - significant portion of customers viewed the merging parties' brands as their first and second choice.
  - predicted increased incentive to raise prices post-merger from the loss of head-to-head competition

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Competitive Effects – Coordinated Interaction

- Coordinated Interaction
  - Actions by a group of firms that are profitable for each of them only as a result of the accommodating reactions of the others. (1992 and 2010 Horizontal Merger Guidelines; Arch Coal at 130.)
  - Includes a range of conduct
    - explicitly negotiated agreements to refrain from competing
    - an understanding that develops from the punishing reactions of competitors to certain behavior
    - parallel accommodating conduct that all competitors instinctively realize is in everyone's best interest (i.e., will produce higher profits)

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Competitive Effects – Coordinated Interaction

(con't)

- Coordinated Interaction
  - A merger causes adverse competitive effects through coordinated interaction, if the merger changes competitive conditions so that:
    - Coordination on price, output or other competitive dimensions is more likely
      - Easier
      - More profitable
    - Any existing coordination will be more successful and sustainable
  - Changes in competitive conditions
    - changes in how firms interact with one another
    - better able to predict one another's response, thus deterring or diminishing competitive behavior
    - better or more complete knowledge of other competitors' costs

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Competitive Effects – Coordinated Interaction

(con't)

- The 2010 Guidelines state that the Agencies are likely to challenge a merger on a coordinated effects theory, if:
  - the market is moderately or highly concentrated;
  - the market shows vulnerability to coordinated conduct; and
  - the Agencies have a plausible theory of how the merger could cause adverse coordinated effects
- Characteristics of Vulnerable Markets
  - Previous collusion
  - Transparency of competitive behavior
    - Terms offered customers are widely known
    - Identity of firms serving particular customers is widely known
    - Firms regularly monitor prices and customer shifts

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Competitive Effects – Coordinated Interaction

(con't)

  - The degree of speed, strength, nature and likelihood of rival responses in the marketplace, which can be affected by
    - homogeneous products
    - ease of customer switching
    - presence of meeting competition clauses
    - large versus small transactions
    - degree of unused capacity
    - degree of gains that are lost or not realized, if rivals respond
  - Lower market elasticity

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Competitive Effects – Coordinated Interaction

(con't)

- Coordinated Interaction – Examples
  - <u>US Airways Group – AMR Corporation</u>
    - DOJ found that, prior to the proposed merger, the two airlines had unique incentives to disrupt coordination that occurs among so-called legacy carriers
      - US Airways used Advantage Fares to undercut non-stop prices of legacy carriers with cheaper connecting flights
      - American, coming out of bankruptcy, had announced plans to grow and add planes, which would increase capacity and be disruptive to settled pricing
    - DOJ concluded that the merger would eliminate or alter these incentives
    - DOJ required divestiture of slots and gates at key airports to create a foothold for discount airlines to re-create the potential for disruption

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Competitive Effects – Coordinated Interaction

(con't)

- Coordinated Interaction – Examples
  - U.S. v. H&R Block, Inc., 2011-2 Trade Cases ¶ 77,678 (D.D.C. 2011)
    - Coordination likely to take the form of reducing the quality of free offerings, which had been championed by the target (Tax Act)
    - Past efforts to limit free products by firms that would remain after the merger
    - Price transparency that facilitates monitoring (despite evidence of email delivered discount coupons)
    - Small and numerous transactions that are spread over many individual consumers
    - Prices that are easily changed
    - Some stickiness in shifting among products
    - Elimination of the target (Tax Act) that played a "special role" in constraining prices because it ignored prevailing price norms

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Competitive Effects – Price Discrimination

- Major point of emphasis in the 2010 Horizontal Merger Guidelines
- If price discrimination is feasible, competitive effects will be evaluated separately across groups of customers

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Competitive Effects – Price Discrimination

(con't)

- Price discrimination is feasible if
  - Suppliers can target certain customers and price differently to them
  - Targeted customers must be unable to defeat the discrimination by buying indirectly from others
- Can affect market definition as well as competitive effects analysis
- Recent Example: Grupo Bimbo – Sara Lee
  - Able to price differently in each regional market, even with national retailers
  - Foundation for defining geographic markets on the basis of location of customers, not manufacturers.

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Supporting Role: Market Definition and Concentration Levels

- 2010 Guidelines officially recognized that Market Definition and Concentration are only the equivalent of circumstantial evidence of competitive effects
  - This is not new. Competitive effects, rather than market definition and concentration, have been the focus of horizontal merger analysis for some time, as described in the 2006 Commentary on the Horizontal Merger Guidelines.
  - Economists have long known that the role of market definition and concentration served solely to provide a basis for inferences about likely competitive effects.
- No longer the necessary starting point of analysis

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Supporting Role: Market Definition and Concentration Levels *(con't)*

Why Bother Then?

- Courts still require market definition (e.g. U.S. v. H&R Block, Inc.)
- Coordinated Effects
  - Identifies the number and relative sizes of competitors that would need to coordinate activities
- Determines if the merger is to monopoly or a so-called 3 to 2 merger that brings heightened scrutiny
- A high market share in a well-defined market gives the DOJ and FTC a "Presumption" of Competitive Harm in Litigated Cases

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Supporting Role: Market Definition – Proof

- Traditional Proof
  - Functionality
  - Ordinary course documents reflecting parties' views of primary competitors
  - Industry recognition
  - Witness testimony as to best customers and substitution
  - Differences or similarities in products and prices
- Quantitative Proof
  - Hypothetical Monopolist Test
  - Critical Loss Analysis
- Recent example of Analysis: H&R Block

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Supporting Role: Market Definition

(con't)

- Analytical Framework: The Hypothetical Monopolist Test
  - The test seeks to divine how the Hypothetical Monopolist's behavior changes when additional products are added to the Monopolist's control – will the Monopolist have the incentive to raise prices?
  - The test is satisfied whenever a price increase would be feasible even if a substantial substitution occurs outside the market – on any one or more products
  - Multiple markets may satisfy the Hypothetical Monopolist Test in a given merger
  - The typical SSNIP ("Small but Significant Non-Transitory Increase in Price") used in the analysis is identified as 5%-10%

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Supporting Role – Market Participants and Market Shares

- Market Participants include
  - Existing firms currently earning revenue in the market
  - Any firm not currently earning revenues in the market that has committed to enter in the near future (i.e., potential entrants)
  - "Rapid entrants"
- "Rapid entrants" is a replacement for the "uncommitted entrants" concept in the 1992 Guidelines
- "Rapid Entrant" is:
  - Not a current producer in the market
  - Would very likely provide "rapid supply responses with direct competitive impact" in the event of a SSNIP

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Supporting Role – Market Participants and Market Shares

(con't)

- "Rapid entrants" concept appears to differ from the old "uncommitted entrants" concept
  - No discussion of presence or absence of sunk costs
  - No requirement that entry occur within one year, although "rapid entry" may require even greater speed

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Supporting Role – Market Concentration

- The 2010 Guidelines continue to use the Herfindahl-Hirschman Index ("HHI") of market concentration, but emphasize that concentration levels are simply additional evidence to be used in conjunction with other evidence
- The Agencies look at
  - The stability of market shares
  - Gaps in market shares between substantial competitors and smaller competitors, which may lead the Agencies to calculate concentration using only the significant competitors in the market

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Supporting Role – Market Concentration

(con't)

- Although HHI concentration thresholds are not to be seen as a rigid screen, DOJ/FTC nonetheless retain the structural presumption of harm at certain concentration levels

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Supporting Role – Guidelines Concentration Thresholds

MARKET CHARACTERIZATION	POST-MERGER LEVEL	PERMITTED CHANGE
Unconcentrated	<1,500	NA
Moderately Concentrated	1,500-2,500	<100
Highly Concentrated	>2,500	<200**

** An increase between 100 and 200 "often warrant scrutiny" and an increase greater than 200 creates a rebuttable presumption of an increase in market power.

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Supporting Role: Entry and Expansion

con't

Role of Entry Conditions:

- High barriers to entry make coordination more likely to be successful and stable
- Easy expansion and repositioning diminishes the likelihood of unilateral effects
- Easy entry decreases the likelihood of any competitive harm
- Easy, effective entry weakens the impact of currently high concentration levels

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Supporting Role: Entry and Expansion

con't
(con't)

- Entry and expansion is given weight only if it will counter the anticipated competitive effects of the merger
- Substantial weight is placed on evidence of actual successful past entry

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Supporting Role: Entry and Expansion

(con't)

- To Offset Competitive Effects, Entry or Expansion Must Be:
  - Timely — "rapid enough
  - Likely
  - Sufficient — replace the competition lost by the merger
    - A firm with the size and scale to replicate one of the merging firms
    - Entrants smaller than the merging firms may do, if they are not at a significant competitive advantage

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Supporting Role: Efficiencies

- Role of Efficiencies:
- A significant reduction in costs can create differences among competitors that make coordination more difficult or less profitable for some
- A decrease in marginal costs can offset any incentive to increase prices so that prices do not increase
- Can rebut the presumption of harm from high market shares and concentration levels

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Supporting Role: Efficiencies

(con't)

- Merger — Specific
- Cognizable
  - Not Arising From Anticompetitive Reduction in Output or Service
  - Net of costs of merger
- Verifiable
- Likely to Offset or Reverse Otherwise Harmful Effects of Merger
  - Efficiencies are a significant factor in DOJ/FTC decisions only when the merger has only slight anticompetitive effects
  - Efficiencies more likely to be recognized when efficiencies reduce marginal costs (not fixed costs such as management) because they are more likely to reduce prices

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Facts are Key – Sources

- Merging parties
  - Evidence that a firm sets price "well above marginal cost" will be viewed as "normally indicat[ing]" coordination or the firm's belief that customers are not highly sensitive to price
  - The Agencies will look for indicia of reliability of efficiency claims in merging parties' documents and data
- Customers
  - Agencies are mindful that customers may have their own agenda
  - Agencies evaluate whether customer views represent consumer views
    - Unless there is evidence to the contrary, impact on direct customers is assumed to be the same as the impact on ultimate consumers (Section 1)

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Facts are Key – Sources

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- Other Industry Participants and Observers
  - Producers of complementary products
    - Viewed as likely aligned with consumer interests
  - Rivals
    - Recognized as a less reliable source on general competitive effects (unless exclusionary conduct is a concern) but a good source for an industry education and details of market behavior of the merging parties
    - Evidence as to the potential for entry and expansion

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Vertical Mergers

Vertical Mergers

- Still no new non-horizontal merger guidelines
- 2010 Horizontal Merger Guidelines do cover mergers with potential competitors, which used to be a part of the non-horizontal merger guidelines
- Competitive Dangers
  - Foreclose or delay rivals' access to inputs or distribution
  - Raising costs of inputs to rivals
  - Facilitating coordination/information exchange

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Vertical Mergers – Enforcement Activity

- Ticketmaster – LiveNation
- Pepsico
- Comcast – NBC
- Google – ITA
- United Technologies – Goodrich (Certain Aspects)

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Merger Remedies

Merger Remedies

- Relying on commitments made to the European Union rather than creating a separate U.S. enforcement mechanism – Cisco-Tanberg merger
- Giving customers an option and mechanism for shifting to divestiture asset acquirer rather than requiring the divestiture of the customer contracts in advance – Election Systems & Software/Premier Election Solutions merger
- Conduct remedies in a vertical merger designed to create an information barrier between acquiring upstream manufacturer and the downstream target that served acquiring firm's competitors – Pepsico and Coca-Cola

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Merger Remedies

(con't)

- Conduct remedy (along with structural remedies) to prevent bundling ticketing services and concert services – Ticketmaster/LiveNation merger
- Conduct remedy (along with a structural remedy) to waive real estate lease radius restrictions to encourage entry and lessee right to extend unilaterally without penalty for five years to avoid price impact until entry can occur – Simon Property Group/Prime Outlets
- Conduct remedies to overcome incentives created by vertical integration of Comcast and NBC to decline to license distribution competitors of Comcast
- Conduct remedies to maintain competitors' access to ITA airline flight and price data – Google/ITA

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DOJ Policy Guide to Merger Remedies

- New guide issued in 2011
- Recognition of Conduct Remedies
- Possible use in vertical mergers and to support structural remedies in horizontal mergers
- Types
  - Firewall provisions
  - Non-discrimination: equal access, efforts, terms
  - Mandatory Licensing
  - Provide information to regulator
  - Prohibitions on retaliation
  - Restrictions on exclusivity or other contract terms

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Hart-Scott-Rodino Act Forms and Rules

HSR – The Basics

- Filing generally required for acquisition of voting securities or assets of $76.3 million.
- Variety of exceptions to the filing requirement, e.g., ordinary course transactions
- An initial 30 day waiting period
- Second request

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HSR – Formal Rule on Filing Withdrawals

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- "Pulling and refiling" HSR notifications is a frequently used technique to give the government more time and to try to avoid a "second request"
- Must refile within two business days. No fee but acquirer only must collect and submit any 4(c) documents created while the first filing was pending
- An informal practice that the FTC formalized in June 2013
- Only significant new element is deeming HSR notifications withdrawn if the acquiring party makes SEC filings ending a tender offer or merger agreement

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HSR – Filings for Patent Licenses

- Rule essentially for the pharmaceutical industry only.
- The FTC amended the HSR Rules, in Rule 801.2(g), to require a filing, assuming the other jurisdictional tests are satisfied, whenever the transfer of exclusive rights to a patent or part of a patent transfers all "commercially significant rights to the licensee".
- Thus, if a license allows only the licensee to commercially use the patent in a particular therapeutic area or for a specific indication, a filing will be required
- This is so, even if the licensor retains the right to manufacture for the licensee or plans to co-promote, co-market or co-commercialize the product.

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Gun Jumping

"Gun Jumping" Explained

- Premature consolidation of the merging parties
- Premature buyer influence or control of the ordinary course activities of the target
- Premature exchange of competitively sensitive information

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Gun Jumping – Avoiding Premature Control or Influence

- Until closing, the merging parties should conduct their businesses as separate and independent organizations.
- Merging parties should take appropriate care to ensure that routine, ordinary course activities of the seller are not subject to regular review and approval by the buyer.
- The seller, until closing, should remain as the sole and independent decision maker with respect to all of its ordinary course business matters.

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Gun Jumping – Avoiding Premature Control or Influence

(con't)

- Any cooperation or collaboration that could affect the competitive basis on which either one of the parties conducts its business presents a significant risk.
  - In January 2010, the US DOJ fined Smithfield Foods and its Premium Standards Farms subsidiary $900,000 for violating the premerger waiting period requirements of the Hart-Scott-Rodino Act. The DOJ alleged that, in exercising approval over Premium Standard's procurement contracts – which were ordinary course agreements involving large financial commitments – Smithfield prematurely acquired beneficial ownership.

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Gun Jumping – Exchanging Information

- Merging parties should exchange competitively sensitive information only in limited circumstances in which a strong business justification exists and arrangements are made to limit the impact of the exchange.
- Information that can be competitively sensitive includes:
  - Current or future strategic plans
  - Current or future price or fee information
  - Current or future marketing plans or strategies
  - Client lists (where clients are otherwise unknown)
  - Detailed information regarding pending bids, proposals or ongoing customer or supplier negotiations
  - Detailed cost or profit information for individual products
  - New product development
  - Proprietary technologies

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