

# Market Definition, the New Horizontal Merger Guidelines, And the Long March Away from Structural Presumptions

**Deborah A. Garza**

Most merger analysis is a predictive exercise. The enforcement agencies and courts use their best efforts to predict whether a proposed merger will on balance harm consumers through the elimination of competition.

The role of market shares and concentration in that predictive exercise has changed over time. Antitrust has evolved from a world in which the enforcement agencies accorded primary significance to the market shares of the merging firms to one in which market shares play only a minor or supporting role or, in some cases perhaps, no role in determining the agencies' enforcement decision. The new Horizontal Merger Guidelines make clear that today market shares are considered merely "in conjunction with" other evidence to predict the likely effect of a merger, and are not used as an actual "screen" to separate competitively benign mergers from those that may be or are likely to be anticompetitive.<sup>1</sup>

In the "old days," predictions were based on a fairly simple assumption about the effect of concentration on competition—that is, that fewer firms and higher concentration likely leads to less competition. The Department of Justice's Merger Guidelines issued in 1968 stated that the "primary role" of merger enforcement was thus "to preserve and promote market structures conducive to competition."<sup>2</sup> The 1968 Guidelines explained:

[N]ot only does emphasis on market structure generally produce economic predictions that are fully adequate for the purposes of a statute that requires only a showing that the effect of a merger "may be substantially to lessen competition, or to tend to create a monopoly," but an enforcement policy emphasizing a limited number of structural factors also facilitates both enforcement decision-making and business planning which involves anticipation of the Department's enforcement intent.<sup>3</sup>

Back at that time, the agencies and courts relied on four-firm market concentration ratios to predict a merger's likely effect. According to the 1968 Guidelines, the DOJ would ordinarily challenge a merger resulting in the four largest firms controlling 75 percent or more of the market if (for example) the acquiring firm had a four percent share and the acquired firm's share was four percent or more.<sup>4</sup> If the four-firm concentration ratio (CR4) was less than 75, the DOJ would ordinarily challenge a merger where the acquiring firm had a five percent share and the acquired firm's share was five percent or more.<sup>5</sup> In other words, in a "highly concentrated" market (as defined by the

■ *Deborah Garza is a partner in the law firm Covington & Burling, LLP. She was formerly Acting Assistant Attorney General and Deputy Assistant Attorney General for Regulatory Matters at the U.S. Justice Department Antitrust Division from 2007 to January 20, 2009, and Chair of the Antitrust Modernization Commission. She was also involved as a Special Assistant to the Assistant Attorney General in revisions to the Justice Department Merger Guidelines released in 1984. Ms. Garza thanks Covington & Burling associate Jesse Gurman for his assistance with this essay.*

<sup>1</sup> U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 5.3 (2010) [hereinafter 2010 Guidelines], available at <http://ftc.gov/os/2010/08/100819hmg.pdf>.

<sup>2</sup> U.S. Dep't of Justice, Merger Guidelines § 2 (1968) [hereinafter 1968 Guidelines], available at <http://www.justice.gov/atr/hmerger/11247.pdf>.

<sup>3</sup> *Id.* § 2.

<sup>4</sup> *Id.* § 5.

<sup>5</sup> *Id.* § 6.

1968 Guidelines), a merger could not result in the merged firm controlling as much as eight percent of the relevant market. Even in any “less highly concentrated market,”<sup>6</sup> no merger could result in a single firm controlling more than 10 percent of the market.<sup>7</sup> These market share limits were based on court decisions reflecting legislative intent to shelter smaller businesses and stop a perceived so-called rising tide of concentration, rather than on sound empirical evidence demonstrating actual effects on competition at such levels of concentration.<sup>8</sup>

By the time of the 1982 Guidelines, merger analysis had become more refined, but retained a structural presumption. The CR4 was replaced by the Herfindahl-Hirschman Index (HHI), which better predicted a merger’s impact on concentration by considering all firms in the market and taking account of their relative size.<sup>9</sup> Under the 1982 Guidelines, a merger resulting in an HHI of 1000 or less (imagine at least ten equally-sized firms)—corresponding to a CR4 of 50 or less—was considered to be immune from challenge. A merger resulting in an HHI between 1000 and 1800, with an increase of 100 or more, was “more likely than not”<sup>10</sup> to be challenged, unless other factors, such as ease of entry or efficiencies indicated otherwise. And a merger resulting in an HHI of 1800 or greater (imagine about six or fewer equally-sized firms)—corresponding to a CR4 of 70 or more—with an increase in the HHI of 100 points or more was “likely” to be challenged.<sup>11</sup> Thus, a merger resulting in a CR4 of 70 between a 10-percent firm and a five-percent firm was presumptively subject to challenge.

The 1982 Guidelines thereby established a clear “safe harbor” that was lacking in the 1968 Guidelines and set the bar of presumptive challenge higher, but not shockingly so. By the terms of the 1982 Guidelines, moreover, it would be difficult to prove other factors (including efficiencies) sufficiently to overcome the presumption of anticompetitive effects. The 1982 Guidelines explained the connection between concentration and the exercise of market power: first, a single firm with a larger share of supply is more likely to be able profitably to raise price by unilaterally restricting its own output (i.e., to exercise market power); second, collective action is more plausible where fewer firms control a substantial percentage of total supply.<sup>12</sup>

The 1968 and 1982 Guidelines solved the prediction problem by establishing relatively straightforward structural presumptions that could be applied with (seemingly) relative ease. They provided a reasonable degree of certainty for businesses, though the empirical basis for the prediction was shaky. The 1968 and 1982 Guidelines also put a premium on market definition. Because of the significance of market shares and concentration-based presumptions, the fight in court, as well as before the agencies, often turned on how the relevant markets were defined.

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<sup>6</sup> *Id.*

<sup>7</sup> The DOJ could have challenged mergers below even these thresholds in industries experiencing a trend toward concentration over the prior five to ten years. *See id.* § 7.

<sup>8</sup> *See, e.g.,* United States v. Philadelphia Nat’l Bank, 374 U.S. 321 (1963). *See also* Oliver Williamson, The Merger Guidelines of the U.S. Department of Justice—In Perspective, Remarks at the 20th Anniversary of the 1982 Merger Guidelines (June 10, 2002), *available at* <http://www.justice.gov/atr/hmerger/11257.htm>, for a brief discussion of work on the “structure, conduct, performance (SCP) approach.”

<sup>9</sup> *See* U.S. Dep’t of Justice, Merger Guidelines § III.A (1982), *available at* <http://www.justice.gov/atr/hmerger/11248.pdf>.

<sup>10</sup> *Id.* § III.A.1.

<sup>11</sup> *Id.* The 1982 Guidelines also created a presumption against any merger that would increase the share of a firm holding 35 percent of the market by more than one percent.

<sup>12</sup> *Id.* § III.A; *see also* U.S. Dep’t of Justice, Merger Guidelines § 3.10 (1984) [hereinafter 1984 Guidelines], *available at* <http://www.justice.gov/atr/hmerger/11249.pdf>.

Almost as soon as the 1982 Guidelines were released, however, they were revised to respond to concerns that overly rigid application of the HHI thresholds could erroneously prohibit mergers that, in particular, would enable U.S. based firms to compete more effectively in world markets (at the time concern centered on more efficient Japanese firms). The business community desired a more nuanced analysis, albeit at the necessary expense of certainty.

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Thus started the long march away from structural presumptions and the importance of defining markets to where we are today. The 1982 Guidelines were revised in 1984 to soften the structural presumption. For example, a statement was added that “market share and concentration provide only the starting point for analyzing the competitive impact of a merger.”<sup>13</sup> The DOJ would expressly consider “all other relevant factors that pertain to” a merger’s likely effect on competition.<sup>14</sup> Nevertheless, the 1984 Guidelines also provided that the DOJ would “focus first” on market concentration in any investigation.

A primary goal of the 1992 Guidelines was to further de-emphasize the importance of the HHIs in favor of an analysis that focused on the “story” of competitive effects—that is, the specific theory of competitive harm. The 1992 Guidelines also emphasized so-called unilateral effects analysis as a theory of harm separate from coordinated effects, focused on the ability of the merged firm to unilaterally raise the price of its product.<sup>15</sup> Nevertheless, the 1992 Guidelines continued to state that the enforcement agencies’ first step would be to assess whether the merger would significantly increase concentration. They retained the same HHI standards established in the 1982 Guidelines, removed the language of presumption from the 1000–1800 range, but continued to warn of a presumption of illegality for mergers in the 1800/100+ range. Although the presumption could be overcome, the 1992 Guidelines continued to be tough on the evidence needed to prove countervailing factors, placing an arguably disproportionate burden on merging firms to prove efficiencies and entry.

So what happened between 1992 and 2010? For one thing, the 1992 Guidelines became significantly out of synch with actual agency practice. It was clear based on the enforcement record that mergers at or somewhat above the 1800/100 range were *not* presumptively subject to challenge (at least not outside the world of grocery stores and retail gasoline mergers where, for political reasons, the relevant threshold was even lower).<sup>16</sup> For most mergers to draw a challenge, particularly outside of these two industries, the post-merger HHI had to be at least 2400/200 or higher, and the bulk of challenges targeted HHIs substantially higher than these thresholds.<sup>17</sup> The apparent discrepancy between the guidelines and actual practice discouraged at least one court

<sup>13</sup> 1984 Guidelines, *supra* note 12, § 3.11. The 1984 Merger Guidelines also softened the presumption language, changing “more likely than not” to “likely” and removed the statement that close cases would be resolved against the merging parties.

<sup>14</sup> *Id.*

<sup>15</sup> Dennis Carlton has explained the dichotomy between unilateral and coordinated effects in the 1992 Merger Guidelines is somewhat confused and probably confusing to businesses as well as the courts. *See, e.g.,* Dennis W. Carlton, Comment on Department of Justice and Federal Trade Commission’s Proposed Horizontal Merger Guidelines § II.D (June 4, 2010), available at <http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00034.pdf>.

<sup>16</sup> *See* Fed. Trade Comm’n, Horizontal Merger Investigation Data, Fiscal Years 1996–2007 tbls. 3.1–3.6 (2008), available at <http://www.ftc.gov/os/2008/12/081201hsrmergerdata.pdf>.

<sup>17</sup> *See id.*

<sup>18</sup> *See* FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109, 129 (D.D.C. 2004) (“[T]his case is not one in which the post-merger increase in HHI produces an overwhelming statistical case for the likely creation or enhancement of anticompetitive market power. . . . Indeed between 1999 and 2003, only twenty-six merger challenges out of 1,263 (two percent) occurred in markets with comparable concentration levels to those argued here.”).

from condemning a merger based on HHI thresholds.<sup>18</sup> It also led the Antitrust Modernization Commission (AMC) to recommend that the 1992 Guidelines be updated.

In fact, except in court pleadings, the agencies simply no longer relied much on market concentration as a general screen. According to a former head of the Federal Trade Commission Bureau of Competition, under her watch, staff recommendations to challenge a merger rarely even mentioned relevant markets, much less HHIs, at least until it was time to draft a complaint.<sup>19</sup> Instead, the enforcers had come increasingly to rely on unilateral effects stories and direct evidence of likely price effects where it was available, such as studies comparing prices where the merging companies competed and did not and merger simulation models.

But because the 1992 Guidelines talked in terms of markets and market concentration, courts have generally assessed mergers that way,<sup>20</sup> and the agencies were beginning to lose cases in court due to skepticism about seemingly overly narrow, even gerrymandered, markets.<sup>21</sup> The agencies faced three unhappy choices: to litigate a case that is different from the one they investigated; to convince the courts that it is unnecessary to define a market (despite precedent and contrary to what the agencies' own Guidelines said); or, to convince the courts to accept narrow markets, possibly comprising only the merging parties and/or small groups of customers.<sup>22</sup> This dilemma is what led to revising the 1992 Guidelines.<sup>23</sup>

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The 2010 Guidelines arguably have moved as far away from market structure presumptions as possible given the state of the law. They abandon the analytical framework of prior guidelines in favor of describing principal analytical techniques and types of evidence used to assess a merger and make plain that the agencies' analysis need not start with nor even necessarily use market definition. They explain that market shares are often one "useful indicator of likely competitive effects."<sup>24</sup>

The 2010 Guidelines also substantially increase the HHI thresholds to more closely reflect enforcement reality. The 1000 HHI safe harbor has become 1500 and the 1800 threshold has become more than 2500 (imagine four equally sized firms, instead of six). The highly concentrated presumption has been retained where the post-merger HHI increases by more than 200 (rather than 100) points, though the presumption is subject to rebuttal by "persuasive evidence" that the merger would not likely enhance market power.<sup>25</sup>

<sup>19</sup> See Fed. Trade Comm'n, Transcript of Unilateral Effects Analysis and Litigation Workshop 184–87 (Feb. 12, 2008) (testimony of Susan Creighton) [hereinafter FTC Workshop], available at <http://www.ftc.gov/bc/unilateral/transcript.pdf>; see also Evanston Northwestern Healthcare Corp., FTC Docket No. 9315, at 54 (Aug. 6, 2007) ("Although the courts discuss merger analysis as a step-by-step process, the steps are, in reality, interrelated factors, each designed to enable the fact-finder to determine whether a transaction is likely to create or enhance existing market power."), available at <http://www.ftc.gov/os/adjpro/d9315/070806opinion.pdf>.

<sup>20</sup> But see FTC Workshop, *supra* note 19, at 167–70 (testimony of Judges Diane Wood and Douglas Ginsburg); *United States v. Baker Hughes Inc.*, 908 F.2d 981, 984 (D.C. Cir. 1990) ("Evidence of market concentration simply provides a convenient starting point for a broader inquiry into future competitiveness.").

<sup>21</sup> See Creighton testimony, *supra* note 19, at 184–89.

<sup>22</sup> See *id.*; see also *FTC v. Whole Foods Mkt., Inc.*, 502 F. Supp. 2d 1 (D.D.C. 2007); *United States v. Oracle*, 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

<sup>23</sup> Cf. U.S. Dep't of Justice & Fed. Trade Comm'n, Commentary on the Horizontal Merger Guidelines (2006), available at <http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf>.

<sup>24</sup> 2010 Guidelines, *supra* note 2, §§ 5, 5.3.

<sup>25</sup> *Id.* § 5.3. The agencies may also measure market concentration using the number of "significant competitors."

The 2010 Guidelines thus better reflect how the agencies actually assess mergers.<sup>26</sup> But they are no panacea. In the first instance, by throwing out the structural screens of the older guidelines, the new guidelines may also substantially erode the predictability of enforcement decision-making and, thus, certainty for business planning “which involves anticipation of the Department’s enforcement intent.”<sup>27</sup>

Second, it is unclear how well the agencies will fare in preliminary injunction hearings without relying on some sort of market share screen. Although the 2010 Guidelines contain a rebuttable 2500/200+ presumption, the very efforts the agencies have made to diminish the significance of market shares and concentration should make it more difficult to rely on them in court, and, indeed, there is no apparent empirical basis establishing their predictive reliability in general or with respect to specific industries. It may thus remain a challenge for the government to put on its entire competitive effects case. Moreover, because in any enforcement action, the agencies will “normally identify one or more relevant markets,” they may continue to face a significant challenge in proving credible-sounding relevant markets in many unilateral effects cases.

Third, the upward pricing pressure (UPP) indices and margin-based analysis with which the agencies apparently intend to effectively replace HHIs in cases alleging unilateral effects (effectively, most cases) have their own significant difficulties. The UPP is untested as a merger screen. As others have noted, there is no empirical analysis supporting its predictive value in assessing mergers.<sup>28</sup> There are also both practical and conceptual limits to its application, which are beyond the scope of this essay but extremely important.<sup>29</sup> Ultimately, what we most need to support sound merger enforcement are further study of the economic foundations of merger policy (including the relationship between concentration and other market characteristics and market performance) and retrospective study of past merger enforcement decisions, which had been called for by the AMC to provide a better basis for consensus and for assessing the efficacy of current enforcement policy.<sup>30</sup> ●

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<sup>26</sup> Even the higher thresholds may be somewhat misleading based on the agencies’ own statistics. See Carlton, *supra* note 15, § II.A.

<sup>27</sup> See 1968 Guidelines, *supra* note 2, § 2 (quoted *supra* p. 1).

<sup>28</sup> See Carlton, *supra* note 14, § III, ¶ 27.

<sup>29</sup> See generally *id.* § III; Malcolm B. Coate & Joseph J. Simons, *Critical Loss vs. Diversion Analysis: Clearing up the Confusion*, COMPETITION POL’Y INT’L (Antitrust Chronicle No. 1, Dec. 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1562006](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1562006).

<sup>30</sup> See ANTITRUST MODERNIZATION COMM’N, REPORT AND RECOMMENDATIONS 10 (2007) (recommendation 10), available at [http://govinfo.library.unt.edu/amc/report\\_recommendation/amc\\_final\\_report.pdf](http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf).