FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

OFFICE OF
THE CHAIRMAN

AUTHORIZED
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Lloyd Constantine, Esquire
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Dear Mr. Constantine:

The Federal Trade Commission appreciates our having been afforded an opportunity to comment upon the proposed Horizontal Merger Guidelines of the National Association of Attorneys General ("NAAG Guidelines" or "Guidelines"). We also thank you for granting us an extension of time in which to comment.

We have two principal concerns with the proposed NAAG Guidelines. We believe that the NAAG Guidelines do not adequately take into account the dynamic nature of competition, and the ability of market forces to forestall most attempts to restrict output and elevate prices to the detriment of consumers. In particular, the Guidelines tend to define markets so narrowly that applying them will often overstate the degree of market power that the merged firm will possess.

Second, the NAAG Guidelines place more emphasis on market share data than we believe is warranted. As the Supreme Court has cautioned, "statistics concerning market share and concentration, while of great significance, [are] not conclusive indicators of anticompetitive effects." United States v. General Dynamics Corp., 415 U.S. 486, 498 (1974). These statistics are "the primary index of market power; but only a further examination of the particular market -- its structure, history and probable future -- can provide the appropriate setting for judging the probable anticompetitive effect of the merger." Brown Shoe Co. v. United States, 370 U.S. 294, 322 n.38 (1962). By overemphasizing these statistics, the NAAG Guidelines do not adequately address the standard established by the Congress when it enacted Section 7: whether "the effect of ... [an] acquisition may be substantially to lessen competition, or to tend to create a monopoly." As a result, the Guidelines are inconsistent with most recent case law interpreting Section 7 of the Clayton Act, and may have the potential to harm consumers. We discuss these concerns in greater detail below.

Market Definition

We endorse the NAAG Guidelines' focus (at page 3) on "prevent[ing] firms from attaining market or monopoly power." The Commission believes, however, that the Guidelines take too limited a view of both the substitute products and alternative sources of supply available to consumers. If the markets defined are too narrow, as may often be the case under the Guidelines approach, the degree of market power that the merging firms will possess after a merger will be overstated, although, in some cases, narrow market definition might understate market power. We believe that the proposal to exclude a product from the market unless it is (1) comparable in price to the provisionally identified product and (2) at least 75 percent of consumers deem it to be a functional substitute for the product of the merging firms would tend to eliminate substitute products and alternative sources of supply from a market.[1] Both of these criteria are inconsistent with a central tenet of economics: consumers make decisions at the margin.

Regarding the price criterion, the Guidelines state that "a functionally suitable substitute which is significantly more expensive than the relevant product will not discipline an exercise of market power until the price of the relevant product has been raised to a level comparable to the substitute." NAAG Guidelines at 12 n.22. But every product (and service) is a bundle of characteristics, including quality, service and convenience, as well as price. Many consumers choose a lower-priced product because the additional benefits of the "deluxe" alternative are "not worth" the higher price. If, however, the price differential between the "standard" and "deluxe" models narrows, at least some consumers will decide that the extra features of the "deluxe" model are worth the higher price. Even a product that differs significantly in price may therefore constrain the exercise of market power.

We believe that all actual and potential sources of supply that may emerge in response to a anticompetitive price increase should be included in the relevant market. Demand elasticity is

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1 We agree that "hard evidence" is desirable and that self-interested speculation and unsubstantiated predictions should be rejected. The Guidelines' requirement for "hard evidence" in market definition, that actual substitution has occurred, however, may eliminate from the market substitute products that could constrain the exercise of market power. Particularly if the market has been competitive, purchasers may have had no reason to change their current buying habits, although they may be quick to do so in the future in response to a price increase.

therefore critical to proper market definition. Although precise supply and demand elasticities are difficult to estimate, imperfect estimates are likely to yield better results than untested rules of thumb. For these reasons, the Commission believes that the tests established by the Department of Justice _Merger Guidelines_ are likely to yield more accurate results than the 75 percent criterion of the _NAAG Guidelines_. For example, the _NAAG Guidelines_' market definition methodically might well put General Motors and Toyota automobiles in separate markets, a result that seems inconsistent with the vigorous competition between these products. If small percentages of customers switch to alternative products in response to a price increase, the overall effect may make any attempt at a price increase unprofitable. In addition, the incentive to attempt to exercise market power is best measured by the amount of consumption lost due to a significant price increase, not the number of customers, especially in input markets where buyers differ in size.

Emphasis on Structural Measures

We believe that merger analysis should consider a variety of factors in addition to concentration data to assess whether a merger will increase the likelihood that firms will be able to increase prices to consumers. Entry conditions, for example, are a critical factor, as the proposed _Guidelines_ recognize. _Guidelines_ at Section 5.1; _see also_ _United States v. Waste Management, Inc._, 743 F.2d 976, 981-84 (2d Cir. 1984). We believe that the key question regarding entry is whether entry, or the threat of entry, will make it unprofitable for firms in a market to exercise their market power. If entry can be sufficiently rapid, and the competitive effects of entry would be sufficiently long lasting, the threat of entry serves to deter price increases, even in the short term. For this reason, the entry standard proposed by the _Guidelines_, which would limit consideration of potential entrants to those likely to accomplish easy and meaningful entry within one year, may have the effect of including only those firms already in the market and excluding potential entrants that would constrain the exercise of market power. Many other factors are relevant to this question, whether a merger will increase the likelihood that firms will be able to increase prices to consumers by explicitly or tacitly colluding. _See, e.g._, R. Posner, _Antitrust Law: An Economic Perspective_ 56-70 (1977). Below we consider only a few of the other determinants. We believe the _NAAG Guidelines_ should explicitly and meaningfully consider each of them, as well as the other factors cited in the 1982 _Statement of the Federal Trade Commission Concerning Horizontal Mergers_ and in the _Merger Guidelines_ of the U.S. Department of Justice.

Another factor is the relationship among the firms in the industry. For example, in finding two hospitals acquisitions illegal, the Commission cited the tradition of cooperation among the hospitals in the local market. Hospital Corp. of America, 106 F.T.C. 361, 500-01 (1985). In affirming our decision, the Seventh Circuit observed that "a market in which competitors are unusually disposed to cooperate is a market prone to collusion." Hospital Corp. of America v. FTC, 1986-2 Trade Cas. (CCH) Para. 67,377, at 61,992 (7th Cir.).

A third factor is the homogeneity of the relevant product. Firms will find it easier to reach an anticompetitive consensus regarding products that are similar. In contrast, they may find it quite difficult to agree on prices for products that differ in quality or for product lines containing many distinct products.

We appreciate the difficulty of assessing each of these factors (and the many other factors) individually, and then considering them together to evaluate the likelihood that a merger might lead to collusion (of the exercise of market power by a dominant firm). We also appreciate the values of "predictability" and "consistency of enforcement." NAAG Guidelines at 26. On balance, however, we believe that basing merger enforcement primarily on concentration levels will result in challenges to mergers that are either beneficial to consumers or benign. We believe we can best serve the public interest by undertaking a careful evaluation of the likely consequences of each merger, and thus satisfying the Supreme Court's direction that we examine "the particular market -- its structure, history and probable future." Brown Shoe Co., 370 U.S. at 322 n.38; accord, General Dynamics, 415 U.S. at 498.

The Law

The NAAG Guidelines, by emphasizing structural data over other economic evidence, differ from the approach to Section 7 taken in most recent cases. The Supreme Court has not addressed substantive merger law in over a decade, but its last pronouncements on the subject signaled the importance of looking beyond the structural evidence to other economic evidence in assessing the probable competitive effects of a merger. United States v. General Dynamics Corp., 415 U.S. 486 (1974)(allowing a merger of two coal producers, despite showing of high market shares and high concentration, because "other pertinent factors" indicated that acquired firm's market share overstated its competitive significance); United States v. Citizens & S. Nat'l Bank, 422 U.S. 86 (1975)(permitting consolidation of several banks in Atlanta because evidence showed little or no effect on competition, even though concentration and the market share of the acquiring bank in the relevant market were both high). Moreover, other decisions over the past several years in closely related areas have underscored the Court's preference for more flexible analysis, taking into account a broad range of economic evidence, rather than relying on more rigid decision rules. See, e.g., Continental T.V. v. GTE Sylvania, Inc., 433 U.S. 36 (1977)(overturning per se rule against non-price vertical restraints); Broadcast Music, Inc. v. Columbia Broadcasting System, Inc., 441 U.S. 1 (1979)(permitting horizontal agreement relating to pricing of copyright materials); NCAA v. Board of Regents of the University of Oklahoma, 468 U.S. 85 (1984)(rule of reason applied to horizontal agreement to restrict output); Jefferson Parish Hospital District No. 2 v. Hyde, 466 U.S. 2 (1984)(holding that, in a tying case, "the character of demand" rather than the "functional relationship" should determine whether there are two products or one). In contrast with the NAAG Guidelines' strict reliance on structural criteria, and consistent with the clear trend in Supreme Court jurisprudence, the lower courts have "shown a greater willingness to consider additional economic evidence." See ABA Antitrust Section, Monograph No. 12, Horizontal Mergers: Law and Policy 170-71 (1986) and cases cited therein. See also FTC v. PPG Industries, Inc., 798 F.2d 1500 (D.C. Cir. 1986); Hospital Corp. of America v. FTC, 1986-2 Trade Cas. (CCH) Para. 67,377 (7th Cir.).

In sum, we are concerned that application of the NAAG Guidelines will tend to overstate the probability that a merger will have substantial anticompetitive effects, and to block mergers that have the potential to lower prices to consumers.[2] Therefore, we suggest that NAAG consider modifying its draft Guidelines along the lines outlined in this letter.

By direction of the Commission. The separate views of Commissioners Bailey and Azcuenaga are attached.

Daniel Oliver

Daniel Oliver
Chairman

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2 We are concerned that the Guidelines do not appear sufficiently to recognize the importance of efficiencies from mergers. While potential wealth transfers from mergers may be an important concern of Section 7, there is also a considerable literature that argues that Congress considered the promotion of efficiency as an important goal of the antitrust laws, and that efficiencies are a major benefit of many mergers. See, e.g., Calvani, Consumer Welfare Is Prime Objective of Antitrust, Legal Times, Dec. 24-31, 1984, at 14; R. Bork, The Antitrust Paradox 50-71 (1978).

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OFFICE OF THE COMMISSIONER

March 6, 1987

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Dear Mr. Constantine:

The Federal Trade Commission has responded to your request for comments on the Horizontal Merger Guidelines of the National Association of Attorneys General. You previously received a separate letter from Chairman Oliver. Because I do not fully agree with either letter, I offer a somewhat different perspective

The NAAG Guidelines seem to emphasize a strong market-structure approach to prosecutorial decision-making. The Supreme Court has not directly dealt with this market-structure issue since its 1974 decision in General Dynamics. However, as the Chairman's letter notes, some recent lower Court decisions such as Waste Management (1984) and Calmar (1985) indicate that additional economic analysis is finding its way into Section 7 cases. There are, however, equally recent opinions that point to a continuing emphasis on market structure as the primary factor in analyzing horizontal mergers. The Court of Appeals in Monfort v. Cargill, 761 F.2d 570 (10th Cir. 1985), relied primarily on market structure in finding a merger presumptively unlawful.* See also FTC v. Coca Cola, 1986-2 CCH ¶67,208 (D.D.C. 1986).

In my own view, the Courts should take account of a variety of factors other than market shares. The 1982 Statement of the Federal Trade Commission Concerning Horizonal Mergers provides information in this regard, as do Commission decisions in Section 7 cases since 1982, see e.g., Hospital Corporation of America, Docket No. 9161, 101 FTC 361 (1985), affirmed 1986-2 CCH ¶67,377 (7th Cir. 1986).

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* The decision, of course, no longer can be cited as precedent. However, the Supreme Court reversed on other grounds and did not reject the lower court's reasoning. Therefore, it is reasonable to suppose that the Tenth Circuit would rely primarily on market structure in its next horizontal merger case.

At bottom, of course, the differences between the NAAG Guidelines and the Commission's Statement reflect differences in opinion among public officials in the reasonable exercise of discretion. I look forward to continued discussions with NAAG about matters of common interest.

Sincerely,

Patricia P. Bailey

Patricia P. Bailey
Commissioner

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
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OFFICE OF
THE COMMISSIONER

March 6, 1987

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Dear Mr. Constantine:

Thank you for the invitation, extended to the Federal Trade Commission, to comment on the draft of the proposed Horizontal Merger Guidelines of the National Association of Attorneys General ("NAAG Guidelines"). Because my views differ in some respects from the comment submitted by the Commission, I submit this letter as a separate comment on the proposed NAAG Guidelines.

I have several concerns with the present draft of the NAAG Guidelines. In particular, it appears that the Guidelines rely on standards for market definition that will tend to define markets that are inappropriately narrow, which may result either in challenges to beneficial mergers or in failure to challenge anticompetitive mergers. I am also concerned that the Guidelines may be interpreted to eliminate the "safe harbor" for mergers that is established in the Department of Justice Merger Guidelines. In addition, the draft NAAG Guidelines depart somewhat from the Department of Justice guidelines in assessing the likelihood of entry and may understate the role of entry in deterring anticompetitive behavior. Finally, the draft guidelines appear to omit consideration of several important factors affecting the likelihood of anticompetitive behavior that are considered by the Federal Trade Commission and the Antitrust Division of the Department of Justice in enforcing the federal antitrust laws.

Overall, the NAAG Guidelines appear to give insufficient recognition to the beneficial effects of many mergers. Mergers play an important and positive role in a free enterprise economy by constraining inefficient management, facilitating the efficient flow of investment capital and permitting existing productive assets to be used for their most valuable purpose. Many mergers and acquisitions do not raise any antitrust concerns.

Market Definition

I agree with the NAAG Guidelines that careful market definition is essential to effective merger enforcement. If markets are defined too narrowly, the market power of the merged firm is likely to be overstated, and mergers that are without anticompetitive effects may be subjected to antitrust scrutiny. The use of inappropriately narrow market definitions may also result in understated market shares or suggest that merging firms operate in distinct markets, allowing anticompetitive mergers to escape antitrust challenge. The principles that the NAAG Guidelines propose to apply to product market definition appear likely to contribute to the delineation of inappropriately narrow markets, although they may at times lead to acceptance of markets that are inappropriately broad. There are three features of the NAAG Guidelines that contribute to this result.

First, the NAAG Guidelines propose to include in an antitrust market only those substitutes for a product that are comparably priced. If this criterion of comparably priced products is strictly applied, it is likely to contribute to mistaken market definitions. Most products have several features and the value of a product to consumers depends on the value consumers place on the various characteristics of the product. Products are substitutes not solely because they have similar prices but because the products provide common characteristics or fill common needs at comparable cost. A barrel of residual fuel oil has a quite different price from a thousand cubic feet of natural gas. An electric utility may nevertheless find them to be close substitutes if the utility takes into account differences in Btu content, differences in maintenance costs and differences in pollution control expenditures. Similarly, a particular Chevrolet may have a significantly different price from a particular Toyota, yet customers may find these automobiles to be close substitutes after taking into account differences in maintenance costs, fuel consumption, expected lifetime, comfort and resale value.

Second, the NAAG Guidelines propose to include in an antitrust product market only those products that are suitable substitutes for 75% of the customers of the merging firms. Given the way this principle is stated, the 75% figure appears to be much too high. Suppose, for example, that two merging firms would lose 70% of their customers if they raised their price even 1% after the merger. The principle embodied in the NAAG Guidelines would apparently lead to the conclusion that these firms not only possess market power but that the merged firm would be a monopolist, because only 70% of consumers consider other products to be close substitutes. 1/ Merging firms could not find the exercise of market power profitable, however, if small price increases would cost them 70% of their customers and sales.

Third, the proposed NAAG Guidelines apparently define antitrust product markets based on the proportion of customers, rather than on the proportion of sales, that would be lost in response to a price increase. The degree to which substitution possibilities constrain the exercise of market power, however, depends on the volume of sales that would be lost as a result of a price increase, not the number of customers. Suppose for example, that 35 large customers accounted for 99% of the sales of a particular product but that 50,000 other customers purchased the other 1% of production. If these 50,000 small customers could readily switch to a substitute product in response to a price increase but there were no close substitute in the end use accounted for by the large customers, then focusing on the number of customers rather than the volume of sales could lead to delineation of inappropriately broad product markets. Conversely, even if only a small percentage of customers switch to substitute products in response to a price increase, the price increase will be unprofitable, if these customers are large enough.

Given these features of the draft NAAG Guidelines, I believe that the tests described in the Commission's 1982 Statement Concerning Horizontal Mergers and the Department of Justice's Merger Guidelines are more likely to yield accurate delineation of product markets than the criteria outlined in the NAAG Guidelines.

1/ A perhaps unintended result of the way this principle is stated is that a merged firm could be found to be a monopolist even though it would lose all of its sales if it raised its price. This possibility arises because the NAAG Guidelines appear to apply the substitution test to each individual substitute product rather than to all substitutes collectively. Thus, if 50% of the customers of the merging firms considered one product to be a perfect substitute for the product sold by the merging firms while the other 50% of the customers of the merging firms considered a different product to be a perfect substitute, neither of these products would be considered a substitute under the draft NAAG Guidelines. Nevertheless, the merging firms would lose all their sales if they chose to raise price.

The approach to geographic market definition embodied in the draft NAAG Guidelines is only somewhat less troubling. The proposal that geographic markets be defined to include the suppliers of 75% of the product consumed by customers of the merging firms is very similar to the Elzinga-Hogarty test. 2/ This is one of the criteria that the FTC and the Department of Justice use in evaluating geographic markets. As pointed out in the Commission's 1982 Statement Concerning Horizontal Mergers, however, the "absence of shipments...does not necessarily indicate separate geographic markets, because, in some circumstances, a slight price rise in one area could precipitate shipments from other areas." 3/ Conversely, substantial inter-market shipments may coexist with import restrictions, such as quotas, that preclude any increase in inter-market shipments in response to a price increase. For these reasons, market definition criteria based only on existing shipment patterns do not necessarily lead to the correct conclusion and therefore should be used in conjunction with the other criteria outlined in the FTC Statement Concerning Horizontal Mergers and the Department of Justice Merger Guidelines.

Elimination of the "Safe Harbor"

The draft NAAG Guidelines use the Herfindahl-Hirschman-Index (HHI) to measure concentration and adopt essentially the same thresholds for challenging mergers that are embodied in the Department of Justice Merger Guidelines. The Department of Justice Merger Guidelines, however, state that "[t]he Department will not challenge mergers falling in this region [below 1000] except in extraordinary circumstances," 4/ and that mergers increasing the HHI by less than the threshold amounts are unlikely to be challenged. The NAAG Guidelines do not contain a similar safe harbor, noting only that mergers above the thres-

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2/ See Elzinga and Hogarty, The Problem of Geographic Market Delineation in Anti-Merger Suits, The Antitrust Bulletin, 49 (1973).

3/ Statement of Federal Trade Commission Concerning Horizontal Mergers, 2 CCH Trade Regulation Reporter, ¶4516, at 6901-7 (1982).

4/ Department of Justice, Merger Guidelines, 2 CCH Trade Regulation Reporter ¶4490 at 6879-13 (1984).

holds are likely to be challenged. 5/ The safe harbor provisions of the Department of Justice guidelines serve a useful purpose in assuring members of the business community that transactions of such minimal competitive impact will not be challenged or subjected to lengthy antitrust review.

Other Factors Affecting Merger Analysis

Like the NAAG, I believe that merger analysis should consider factors in addition to concentration data in assessing whether a merger will increase the likelihood that firms will be able to increase prices to consumers. Entry conditions are a particularly important factor, as the proposed NAAG Guidelines recognize. The NAAG Guidelines, however, say that entry within one year must be possible, rather than the two-year period suggested in the Department of Justice Merger Guidelines, on the ground that "during a year consumers will suffer significant harm of the precise nature which the law was primarily enacted to prevent." This view appears to misapprehend the effect of the threat of entry. A key question regarding entry is whether entry, or the threat of entry, will make it unprofitable for firms in a market to exercise their market power. If entry can be sufficiently rapid, and the competitive effects of entry would be sufficiently long lasting, the threat of entry serves to deter price increases, even in the short run. Use of a longer time period for evaluating the likelihood of entry than for delineating the relevant product market reflects that "[w]here new entry involves the dedication of long-lived assets to a market, the resulting capacity and its adverse effects on profitability will be present in the market until those assets are economically depreciated."6/ The threat of this long-run change in industry structure can be a more powerful deterrent to price increases than is short-run substitution. For this reason,

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5/ The draft NAAG Guidelines also differ from the Department of Justice Merger Guidelines in that the thresholds for increases in concentration are halved for mergers in industries in which the HHI has risen by 100 points in the preceding three years (50 points if the HHI is over 1800). I believe it is preferable to take account of trends in concentration and other changes in market conditions as factors affecting the significance of market shares and concentration, rather than to introduce additional concentration thresholds.

6/ Department of Justice, Merger Guidelines, 2 CCH Trade Regulation Reporter ¶4493 at 6879-15 n.22 (1984).

it seems appropriate that antitrust agencies take account of the likelihood of entry over a somewhat longer period than is used for the purpose of product market definition.

Although the draft NAAG Guidelines mention a number of other factors affecting the likelihood of successful collusion that are to be taken into account in one context or another, the NAAG Guidelines omit other important factors identified in the FTC Statement or the Department of Justice Merger Guidelines. Depending on the other circumstances surrounding the merger, factors such as product homogeneity, the availability of transaction or firm specific price and sales data, buyer characteristics, the rate of technological change, the exchange of price or output information, or the existence of mandatory delivered pricing can have an important effect on the likelihood of successful collusion and, if relevant, should be taken into account by antitrust agencies.

Efficiencies

The proposed NAAG Guidelines provide that efficiencies will be considered only in cases where the post-merger HHI is 1800 points or lower and that in such situations efficiencies of five percent or more will make a challenge to a merger "unlikely." This setting of numerical standards for an efficiency "safe harbor" differs from the Department of Justice Merger Guidelines and the 1982 FTC Horizontal Merger Statement.

I agree that evaluation of efficiency evidence in specific cases is important. The Justice Department guidelines provide for consideration of efficiencies, as one factor in exercising enforcement discretion, only if merger-specific efficiencies are proven by "clear and convincing" evidence. The 1982 FTC Statement provides for consideration of efficiencies as a "policy matter" only if the claims are supported by "substantial evidence." The NAAG Guidelines likewise recognize the importance of obtaining evidence, rather than relying on speculation and argumentation.

Adopting a rule that efficiencies of greater than five percent create a "safe harbor" in cases where the HHI is 1800 or lower, but that efficiencies, no matter how large, will be disregarded in cases where the HHI is over 1800 points may be unnecessarily rigid. Some mergers in markets with a HHI below 1800 may be dangerously anticompetitive even though a five percent efficiency gain could be demonstrated. Also, it may not be prudent completely to foreclose consideration of efficiencies, even those of great magnitude that could be established by convincing evidence, in a transaction that would produce a post-merger HHI of slightly over 1800. I question whether antitrust enforcers have enough experience with efficiency issues to promulgate such firm rules.

Conclusion

Two stated purposes of the draft NAAG Guidelines are to provide a "uniform framework for the states" to analyze mergers and to provide guidance to the business community concerning enforcement standards. If differences in state laws and policies are now creating confusion, uniform guidelines for state antitrust law enforcement could promote the goals of consistency and certainty. The NAAG Guidelines, however, take an approach different from the Commission's merger policy and that of the Department of Justice. For this reason, the NAAG Guidelines also have the potential to create confusion where none has existed.

For the reasons outlined above, I believe that applying the NAAG Guidelines would tend to overstate the likelihood that a merger will have significant anticompetitive effects and could lead to efforts to block mergers that are likely to lower, not raise, consumer prices.

Once again, I appreciate this opportunity to comment on the proposed NAAG Guidelines.

Sincerely yours,

Mary Azcuenaga

Mary L. Azcuenaga