

THE PREDICTIVE POWER OF MERGER ANALYSIS

I. Introduction

- A. Merger analysis:
 - 1. By nature predictive
 - 2. Virtually all federal challenges: proposed transactions
- B. My aim: assess the predictive power of current merger analysis
- C. To do that, I'll:
 - 1. Examine the types of evidence courts rely on, focusing on:
 - a. Two issues
 - (1) Market definition
 - (2) Entry
 - b. Recent, well-known cases – today, *Oracle*
 - 2. Review the literature on “merger retrospectives”
- D. My conclusion: predictive power of merger analysis is reasonably good, but it is still not objective or completely on target
 - 1. Merger litigation is quite sophisticated – it’s been refined for many years – but:
 - a. Rarely is any evidence decisive
 - b. So judges must weigh: large mass of complicated and conflicting evidence – a subjective and judgmental process
 - 2. Empirical studies indicate:
 - a. The “marginal” merger – the one that would have been challenged if the government had been more incrementally

more aggressive – has usually resulted in a price increase – typically not large, but significant

b. Studies aren't representative of all marginal mergers, but suggest

(1) May be under predicting harm, to some degree

(2) But system not way off: marginal merger not dramatically anticompetitive or dramatically procompetitive

E. Before I supply details, must mention two complications

1. Like the government and courts:

a. I'll assume:

(1) Just two possibilities

(2) Task: estimate the probability of the first

b. Reality is more complicated, as Howard will explain

2. The incipency standard in the law, which lowers the required probability

II. Incipency Standards

A. Section 7 of the Clayton Act

1. Doesn't prohibit mergers that are "likely" to reduce competition

2. Instead, bars mergers whose effect "*may be* substantially to lessen competition."

3. Suggests: "any significant possibility" of an anticompetitive effect is enough

4. Courts have limited: must be a "reasonable probability" – not specified, but presumably less than 50%

- B. Section 13(b) of the FTC Act
 - 1. Lowers FTC's burden further in a PI action
 - a. Need not show: ultimate success is "likely"
 - b. Only has to raise "substantial" questions
 - c. Suggests FTC can get a PI if it shows court
 - (1) there's a reasonable probability
 - (2) it can later demonstrate a reasonable probability the merger is anticompetitive
 - d. This double reduction in burden has been subject to much criticism
 - 2. Not clear, though, how often courts take this literally – PI usually kills deal
 - 3. But whatever the FTC's exact burden: Section 7 itself doesn't demand a probability greater than 50%

III. Litigation Process: Market Definition

- A. Start with market definition because it's the first and frequently the most critical issue
 - 1. Helps assess market power
 - a. Products outside the market: not significant constraints
 - b. Narrow focus to other products (if any) within the relevant market
 - 2. We have a theoretically precise test: hypothetical monopolist test
 - 3. The difficulty arises in applying it
 - a. Where no clean break in the chain of substitutes
 - b. Merged firm's products surrounded by other products that compete with them to varying degrees

3. How, in practice, is the boundary drawn? By looking at many different types of evidence
 - a. Characteristics of the competing products
 - b. Price differences
 - (1) Across products
 - (2) Across geographic areas
 - c. Company assessments of the issue
 - (1) Whom do they say are their competitors?
 - (2) Whom do they price check?
 - (3) Do they think the merger will give them pricing power?
 - d. Views of others in the industry
 - (1) Customers
 - (2) Competitors
 - (3) Industry Experts
 - e. Economic experts
 - (1) Interpret the other evidence from an economic perspective
 - (2) Offer their own studies
 - (a) From simple (e.g., Elzinga's summary of discount request forms)
 - (b) To complex (McAfee's merger simulation)
4. This laundry list illustrates the process
 - a. We predict in antitrust by examining a wide array of evidence,
 - b. None of which is usually dispositive

5. Each type of evidence, moreover, is often difficult to interpret
- B. Take customer testimony
1. Considerable appeal
 - a. Overarching goal of antitrust is to protect consumers
 - (1) Customers are either final consumers
 - (2) Or intermediate purchasers whose their interests are usually aligned with consumers
 - b. Customers have valuable information:
 - (1) Which products do and do not work for them
E.g., Gorriz, VP of DaimlerChrysler, stated: “only SAP, PeopleSoft or Oracle could service [Daimler’s] need for the HR management.” Oracle 1125-26.
 - (2) If price rises post-merger, would they switch to another product?
E.g., “if Oracle, SAP or PeopleSoft were to increase their price for HRM by 10 percent, Gorriz stated that Daimler ‘would not consider any offer’ from any other vendors.” Oracle 1126.
 2. But customer testimony can be unreliable
 - a. Biased
 - (1) Other customers hurt more by price rise
 - (2) Could favor because of the competitive advantage, even though final consumers worse off
 - b. Unrepresentative

- c. No backup analysis
 - (1) Walker: customer testimony “not backed up by serious analysis that they had themselves performed . . . about the cost of alternatives . . . e.g., how much outsourcing would actually cost, or how much it would cost to adopt other vendors’ products to the same functionality that the Oracle and PeopleSoft products afford.” Oracle 1131.
 - (2) Probably overstated in *Oracle*, but real problem
 - (a) Customers used to dealing with certain suppliers
 - (b) Unfamiliar with others
 - (c) Might take others more seriously if forced

3. The second type of evidence is considerably more technical:

C. Merger simulations

- 1. Perhaps the most significant recent innovation in merger analysis
- 2. Two-step process
 - a. Model the pre-merger equilibrium
 - (1) Requires data
 - (2) But frequently not market definition
 - b. Use the model to simulate the merger
 - (1) Assume firms A and B are no longer independent, but would set prices to maximize their joint profits
 - (2) If the model predicts a significant price increase for the merging firms’ products, but not other products, it is evidence of both unilateral effects and market definition

3. Though a promising method – used at the agencies – it is still in its adolescence
 - a. No court decision has relied on a simulation
 - b. *Oracle* rejected the government’s simulation
 - (1) Model relied on market shares from the government’s proposed market, which the court ruled invalid
 - (2) Used an auction model, but court: prices set through negotiations, not auctions

IV. Litigation Process: Entry

A. Introduction

1. Like market definition, helps assess power
 - a. Merged firm can’t raise price if a new entrant would promptly undercut it
2. Unlike market definition, courts often give it short shrift

B. Three components to entry analysis

1. Timeliness
2. Likelihood
3. Sufficiency
4. I’ll focus: likelihood – the most difficult

C. Courts predict likelihood by looking at: barriers to entry

1. Plausible: obstacles that make entry less likely
2. Most common:
 - a. Capital requirements
 - b. Product differentiation
 - c. Scale economies

- d. Legal restrictions on entry
3. Problem
- a. Barriers may make entry *less* likely, but not *unlikely*
E.g., large capital requirements
 - b. Need to determine *height*
 - (1) How high is too high? When the barrier makes entry *unprofitable*
 - (2) So, real issue, as Guidelines recognize, is profitability
 - (3) Courts rarely evaluate the profitability of entry
4. *Oracle*: especially poor
- a. Ruled: Microsoft a likely entrant – without addressing either barriers or profitability
 - b. K&Z 74-75.
- D. Behavioralist challenge
- 1. “Between 1988 and 1996, the DOJ brought criminal antitrust cases in dozens of industries that, on the surface, appear to have moderate or low entry barriers, including turtles, chain link fences, and bicycle retailers.” Reeves & Stucke 31 (citing Stucke 565-66).
 - 2. What might explain the lack of entry?
 - a. Might firms not enter even when entry would be profitable?
 - b. The short answer: we don’t know – no studies
 - c. There are possibilities consistent with rational profit maximization
 - (1) Price increases: small or short lived.
 - (2) Pricing information: not widely available and costly to obtain

- (3) Markets actually had substantial barriers
- c. Not clear, however, that these explain all or even most cases
- d. If no rational explanation, then: behavioralist possibility – firms are excessively risk averse
- e. Problems
 - (1) Not true in the financial sector
 - (2) Behavioralism literature itself reveals *excessive* entry
 - (a) Documented in empirical and experimental studies
 - (b) Attributed to over optimism or wishful thinking
- e. Why didn't such irrational entry occur in the cartel cases?
 - (1) Suggests real information or entry barriers.
 - (2) But don't know – need empirical case studies
- f. Brings us to final topic: what existing empirical studies tell us about predictive power of merger analysis

V. Empirical Studies

A. Introduction

1. If enforcement perfect: every merger allowed to proceed would benefit consumers – or at least not hurt them
2. If enforcement imperfect, but on target on average:
 - (1) Some mergers would cause price increases
 - (2) But equal number would result in price declines
3. Empirical studies suggest: neither model is accurate

B. Limitations

1. Not a large number of studies
2. Most examine just four industries:
 - a. Banking
 - b. Airlines
 - c. Petroleum
 - d. Hospitals

C. But there is a substantial body of empirical evidence

1. Found almost 30 pertinent studies in the last two decades
2. These studies conclude: vast majority of mergers studied resulted in a price increase – often not large, but significant

D. This suggests

1. Agencies might be somewhat more aggressive
2. But not missing dramatically anticompetitive mergers – or blocking many procompetitive mergers

VI. Conclusion

- A. In short: predictive power of merger analysis seems quite good, though not perfect
 - 1. The litigation process
 - a. Become very sophisticated
 - b. But still confronts courts with a massive and complex record
 - 2. The outcomes
 - a. In the right range
 - b. But historically, we've been somewhat too cautious
- B. For help in enhance the predictive power of merger analysis, we look to this symposium – and the further research it engenders