



The American Antitrust Institute

## AAI PUBLIC INTEREST ADVOCACY WORKSHOP ON MERGERS

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### HOW MERGERS CAN HARM CONSUMERS: BASICS OF ANTITRUST ANALYSIS

Each year, literally thousands of companies have merged in various forms.<sup>1</sup> More than 1,400 merger transactions were filed for the premerger notification to the Antitrust Division of the Department of Justice (DOJ) and the Federal Trade Commission (FTC) in fiscal year 2012 alone.<sup>2</sup> Mergers in general can increase efficiency, promote economies of scale, and enable business owners to sell their firms to someone who might have better management skill for given markets or better positioning in the markets. Many small businesses need an exit strategy in the form of being acquired. The vast majority of mergers raise no anticompetitive concerns, thus the DOJ and the FTC normally clear about 95% of the transactions that are pre-notified to them. Mergers can, however, harm competition in various ways, thus, ultimately, harm consumers. One study about price outcomes of merger transactions showed that nearly 83% of merger transactions resulted in price increase.<sup>3</sup> The study also indicated that the overall average price increase from the studied mergers was more than 7%.<sup>4</sup> The US antitrust laws prohibit certain mergers in order to protect consumers from anticompetitive effects reasonably likely to be generated by those mergers. The ways to harm consumers depend on the competitive relationship between the merging firms. The mergers are, traditionally, analyzed in three types: “horizontal,” “vertical,” and “conglomerate” mergers.

#### I. Horizontal Mergers

A “horizontal” merger generally occurs when one firm acquires another firm that manufactures the same product in the same geographic market. Although a horizontal merger might generate, as noted above, some important procompetitive effects, it may also harm consumers mainly based on two categories of anticompetitive effects: coordinated effects and unilateral effects.<sup>5</sup>

##### a. Coordinated effects

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<sup>1</sup> The word “merger” has a broad meaning in the antitrust law context. It includes not only a merger under the state corporate laws but also a purchase of assets and share of a target company; *See also*, Section 7 of Clayton Act, 15 U.S.C. § 18.

<sup>2</sup> U.S. DEP’T OF JUSTICE & FED. TRADE COMM’N, HART-SCOTT-RODINO ANNUAL REPORT FISCAL YEAR 2012, 1 (2012), *available at* <http://www.ftc.gov/os/2013/04/130430hsrreport.pdf>

<sup>3</sup> John E. Kwoka, *Does Merger Control Work? A Retrospective on U.S. Enforcement Actions and Merger Outcomes* (April 4, 2012), 619 ANTITRUST L.J., vol. 78, 629-34 (2013). The study analyzed price outcomes estimated from forty-six true mergers, three joint ventures and four airline code-sharing consummated between year 1976 and 2006.

<sup>4</sup> *Id.*

<sup>5</sup> *See* U.S. DEP’T OF JUSTICE & FED. TRADE COMM’N, HORIZONTAL MERGER GUIDELINES (2010) [Hereinafter 2010 GUIDELINES], *available at* <http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf>; <http://ftc.gov/os/2010/08/100819hmg.pdf>

Acquisitions among competitors normally increase concentration in the relevant product and geographic market, since one competitor is eliminated; and these acquisitions might raise prices by collusion (either explicit or implicit) or by coordinated behavior that does not arise from an actual agreement. Anticompetitive cooperation is easier when there are fewer participants in the relevant market. Fewer participants in the relevant market make it easier not only to detect (and thus to deter) “cheating” by participants of a cartel agreement, which would itself violate the antitrust law, but also to maintain interdependent coordinated behaviors, known as “conscious parallelism.” Although interdependent coordinated behavior itself does not violate Section 1 and 2 of Sherman Act,<sup>6</sup> and even if each rival’s response to competitive moves made by others is individually rational and not motivated by retaliation or deterrence or intended to sustain an fixed market outcome, it may bring price increases and weaken competitive incentives to reduce prices or to offer better terms to consumers.<sup>7</sup>

b. Unilateral effects

A horizontal merger may create substantial market power and could enable the merged firm to raise the price of products above the premerger level unilaterally. This “unilateral effects” story is likely to occur in a market in which products are differentiated or branded.<sup>8</sup> In such a market, a premerger firm may be reluctant to raise prices since it may lose sales.<sup>9</sup> After a merger with its competitor, however, the merged firm may raise the price because some of its lost sales would be recaptured by sales diverted to the product of the merger partner.<sup>10</sup>

Unilateral effects also may be likely to occur even in a relatively homogeneous product market where “(1) the merged firm’s market share is relatively high; (2) the share of the merged firm’s output already committed for sale at prices unaffected by the output suppression is relatively low; (3) the margin on the suppressed output is relatively low; (4) the supply responses of rivals are relatively small; and (5) the market elasticity of demand is relatively low.”<sup>11</sup> A merged firm may eliminate pre-existing production capabilities or divert the use of capacity away from one relevant market and into another so as to raise the price in the former market.<sup>12</sup>

Horizontal mergers may also threaten competition by limiting the incentives of a merged firm to innovate or introduce new products.<sup>13</sup> The merged firm may stop investments for development undertaken by one of the merged firms if sales of that new product might capture sales of competing product from the other merged firm.<sup>14</sup>

## II. Vertical Mergers

A “vertical” merger typically occurs when one firm acquires either its customer or supplier. Unlike a “horizontal” merger, a vertical merger does not change the total number of competitors in both the acquiring firm’s market and the acquired firm’s market. A vertical integration may promote efficiency to the integrated firm, for example, by reducing

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<sup>6</sup> 15 U.S.C. § 1, 2.

<sup>7</sup> 2010 GUIDELINES, *supra* note 5, at § 7.

<sup>8</sup> *Id.* at § 6.1.

<sup>9</sup> ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS [hereinafter ANTITRUST DEVELOPMENTS], 357 (7th ed. 2012).

<sup>10</sup> *Id.*; 2010 GUIDELINES, *supra* note 5, at § 6.1.

<sup>11</sup> 2010 GUIDELINES, *supra* note 5, at § 6.3.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at § 6.4.

<sup>14</sup> *Id.*; ANTITRUST DEVELOPMENTS, *supra* note 9, at 360.

transaction costs. (The vertically integrated firm can internalize all transactions between its supplier or dealer, thus can avoid the costs of using the marketplace.<sup>15</sup> The vertical merger may also bring more effective way to monitor and its services.<sup>16</sup> ) Hence, the vertical merger is less likely than the horizontal merger to create competitive problems, thus less likely to harm consumers. The vertical merger, however, can still bring harm to consumers in certain ways.

a. Barriers to Entry

A vertical integration may force other entrants in the acquiring firm's market to vertically integrate and enter not only that market but also up or downstream market in order to compete. The need for simultaneous entry may significantly increase costs and delay or even prevent potential entrants to enter the market.<sup>17</sup>

b. Facilitating collusion

A vertical merger may reduce horizontal competition in the upstream market or the downstream market or both levels, where the merging firms operate by facilitating collusion among competitors. Participants in collusion have an incentive to "cheat" by offering a lower price. A vertical integration, especially, by an upstream firm into the retail market, however, may make it easier to detect prices at the retail level so that it is easier for the colluders to detect and punish a "cheater."<sup>18</sup> A vertical merger may also facilitate collusion in the upstream market if it eliminates a particularly disruptive buyer who has significant bargaining power to force sellers to compete with each other.<sup>19</sup>

c. Evasion of Rate Regulation

Some industries are still subject to governmental price regulations. Vertical mergers can permit firms in regulated industries to evade price regulations in either the regulated market or an adjacent market, and ultimately harm consumers.<sup>20</sup> For example, in a case where regulation only permits a regulated industry to charge prices that cover input costs plus a certain rate of return, a regulated firm can overcharge itself for its own inputs, and then pass on the inflated costs to consumers as "legitimate" costs by acquiring one of its own input suppliers.<sup>21</sup>

### III. Conglomerate Mergers

A "conglomerate" merger encompasses all mergers other than horizontal and vertical mergers. An integration of completely unrelated products or activities is called a "pure" conglomerate merger.<sup>22</sup> Mergers between firms that manufacture the same product but in different geographic markets are called "market extension" mergers.<sup>23</sup> When a firm producing one product buys another firm which makes different products that are related to

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<sup>15</sup> Herbert Hovenkamp, FEDERAL ANTITRUST POLICY – THE LAW OF COMPETITION AND ITS PRACTICE, § 9.2b (4th ed. 2010)

<sup>16</sup> *Id.*

<sup>17</sup> U.S. DEP'T OF JUSTICE, NON-HORIZONTAL MERGER GUIDELINES [Hereinafter 1984 GUIDELINES], § 4.212 (1984), available at <http://www.justice.gov/atr/public/guidelines/2614.pdf>; Economies of scale may also constitute an entry barrier if the capacity of minimum efficient scale plants differs significantly at the two levels.

<sup>18</sup> *Id.* at § 4.221.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.* at § 4.23; HOVENKAMP, *supra* note 15, at § 9.3d.

<sup>21</sup> 1984 GUIDELINES, *supra* note 17, at § 4.23.

<sup>22</sup> HOVENKAMP, *supra* note 15, at § 13.1.

<sup>23</sup> *Id.*

each other, this is called a “product extension” merger.<sup>24</sup> Conglomerate mergers involve firms which operate in separate markets, thus, they do not change the total number of competitors in both markets. Therefore, in general, conglomeration has no direct effects on competition, has no direct effect on prices, and is less likely to be challenged under the US antitrust laws.

However, certain conglomerate mergers are still theoretically anticompetitive, and ultimately could harm consumers. For example, even in a highly concentrated market, inclination to raise price or reduce output for the incumbents in the relevant market is still restrained by the presence of a large and capable potential entrant.<sup>25</sup> If, however, this potential entrant is acquired and eliminated from a list of potential entrants, there may be inadequate constraints on the incumbents’ ability to raise price or reduce output.<sup>26</sup> In addition, although a conglomerate merger has no current effects on competition in the given market, the acquiring firm could and would have come into the market *de novo* by setting up its own facilities in a more competitive manner to make the products produced by the incumbents.<sup>27</sup> Therefore, conglomerate mergers could eliminate procompetitive method of entry and harm consumer benefits.<sup>28</sup> It must be said, however, that recent precedents for stopping conglomerate mergers are weak and that arguments based on ideological opposition to large companies or aggregate concentration of resources have not proven effective.

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<sup>24</sup> *Id.*

<sup>25</sup> 1984 GUIDELINES, *supra* note 17, at § 4.111.

<sup>26</sup> This theory is called “Perceived Potential Competition.” *See id.*; *See also*, HOVENKAMP *supra* note 15, at § 13.4a.

<sup>27</sup> *Id.* at § 13.4b.

<sup>28</sup> This theory is called “Actual Potential Competition.” *See id.*