DEPARTMENT OF JUSTICE

CARL SHAPIRO
Deputy Assistant Attorney General for Economics
Antitrust Division
U.S. Department of Justice

UPDATE FROM THE ANTITRUST DIVISION

Remarks as Prepared for the
American Bar Association Section of Antitrust Law Fall Forum
November 18, 2010

Washington, D.C.

INTRODUCTION

I am delighted to have the opportunity to speak here this morning on behalf of Assistant Attorney General Christine Varney and the entire Antitrust Division of the United States Department of Justice. My report on the Division's recent activities is informed by my experience at the Division since March 2009, when I returned to the Division as Deputy Assistant Attorney General for Economic Analysis. After providing an update on the work of the Division as a whole, I will drill down and provide my insights and perspectives on the recently revised Horizontal Merger Guidelines.

CRIMINAL ENFORCEMENT

Cartels are anathema to properly functioning free markets. Accordingly, the Division continues to focus on rooting out and prosecuting cartels and other collusive agreements.

A quick look at the criminal enforcement statistics tells this story persuasively. During Fiscal Year 2010, which ended September 30, the Division filed 60 criminal cases and obtained fines in excess of roughly $550 million. In these cases, 84 corporate and individual defendants were charged. Of the individual defendants sentenced, 76% were sentenced to imprisonment. The average sentence was 30 months and total jail time for all defendants was about 26,000 days. Foreign nationals were sentenced to an average of 10 months in prison. The incarceration of foreign nationals who participated in cartels that were detrimental to the United States and its consumers continues to be a priority of the Division, despite the additional challenges that can arise in such cases.

Table 1: Antitrust Division Criminal Enforcement Data

	FY2006	FY2007	FY2008	FY2009	FY2010
Total Cases Filed	34	40	54	72	60
Defendants Charged	61	57	84	87	84
Fines Obtained	$473m	$630m	$701m	$1,007m	$555m
Total Jail Days Obtained	5,383	31,391	14,331	25,396	26,046

Table 1 displays the Division's criminal enforcement data over the past five fiscal years. The specific numbers vary from year to year, but the Division's commitment to criminal enforcement remains steadfast. These statistics are derived from cases brought against firms and individuals in various sectors of the economy, including: air transportation services; liquid crystal display panels; financial services; Internet services; packaged ice; environmental services; and post-Hurricane Katrina remedial work among many others. Of particular note is our investigation into the municipal bond industry where, thus far, seven defendants have pleaded guilty to bid rigging and related fraud charges. This investigation is being jointly conducted by the Division's New York Field Office, the Federal Bureau of Investigation, and Internal Revenue Service Criminal Investigation unit. We are also coordinating with the Securities and Exchange Commission, the Office of the Comptroller of the Currency, and the Federal Reserve Bank of New York. This kind of joint effort demonstrates the Division's commitment to using all available law enforcement resources to identify and prosecute violations of the antitrust laws.

It probably goes without saying at this point in time, but criminal enforcement relies heavily on our Leniency Program. This program is the Division's single most important investigative tool for detecting cartel activity. Through the Leniency Program, a corporation can avoid criminal conviction and fines, while individuals can avoid criminal conviction, prison terms, and fines, by being the first to confess to participation in criminal antitrust violations, fully cooperating with the Division, and meeting other specified conditions.[1] To that end, we encourage firms to establish comprehensive and thorough compliance and educational programs as means both to deter violations of the antitrust laws and to detect the same.

Criminal enforcement of the antitrust laws continues to be a high priority for the Division. We remain vigilant in detecting and prosecuting these violations to the fullest extent of the law. Ann O'Brien, Senior Counsel to the Deputy Assistant Attorney General for Criminal Enforcement, will be discussing international cooperation in cartel enforcement this afternoon.

CIVIL NON-MERGER ENFORCEMENT

Reviewing and challenging anticompetitive conduct is a critical component of the Division's mission to preserve and promote competition. Table 2 presents the Division's Civil Enforcement Data for the past five fiscal years. The first row in Table 2 provides data on Civil Non-Merger Enforcement, excluding civil contempt petitions.

---

[1] Frequently Asked Questions Regarding the Antitrust Division's Leniency Program and Model Leniency Letters (Nov. 19, 2008), available at http://www.justice.gov/atr/public/criminal/239583.htm.

Table 2: Antitrust Division Civil Enforcement Data

	FY2006	FY2007	FY2008	FY2009	FY2010
Civil Non-Merger Cases Filed[2]	2	2	4	2	4
HSR Filings	1768	2201	1726	716	1166
HSR Investigations Initiated by DOJ	77	81	70	49	55
DOJ Second Requests	17	32	20	16	22
% of HSRs Resulting in a DOJ Second Request	1.0%	1.5%	1.2%	2.2%	1.9%
Total DOJ Merger Investigations Initiated (HSR + Non-HSR)	96	101	84	66	64
Total DOJ Merger Challenges[3]	16	12	16	12	19

During Fiscal Year 2010, the Division resolved its competitive concerns with a negotiated consent decree in four civil non-merger cases. Those cases were: *US v. Smithfield Foods and Premium Standard Farms LLC*;[4] *US v. Idaho Orthopedic Society*;[5] *US v. Adobe Systems, Inc. et. al*;[6] and *US v. KeySpan Corporation*.[7] There also were a number of instances where, following interest by the Division, parties voluntarily chose to alter their practices,

---

[2] These figures include cases filed with a consent decree, settled during litigation, and litigated to judgment, but not civil contempt petitions.

[3] These figures include cases filed and restructured and abandoned transactions.

[4] Documents associated with this case are available at http://www.justice.gov/atr/cases/smith2.htm.

[5] Documents associated with this case are available at http://www.justice.gov/atr/cases/idortho htm.

[6] Documents associated with this case are available at http://www.justice.gov/atr/cases/adobe htm. For a discussion of the economics underlying this case, *see* Ken Heyer and Carl Shapiro, "The Year in Review: Economics at the Antitrust Division 2009-10," *Review of Industrial Organization*, forthcoming, available at http://faculty.haas.berkeley.edu/shapiro/DOJATR2010.pdf.

[7] Documents associated with this case are available at http://www.justice.gov/atr/cases/keyspan htm. For a discussion of the economics underlying this case, *see* Heyer and Shapiro, *op. cit.*

obviating the need for us to take a formal law enforcement action. Sharis Pozen, Chief of Staff and Counsel to the AAG, will be discussing civil non-merger enforcement later this morning.

During Fiscal Year 2011, the Division has already brought two civil non-merger challenges that that the parties have elected to litigate rather than settle. I would like to spend a moment to explain why the Division took enforcement actions in these two cases.

Blue Cross Blue Shield of Michigan

On October 18th of this year, the Division and the Michigan Attorney General filed a civil antitrust lawsuit against Blue Cross Blue Shield of Michigan ("Blue Cross").[8] The complaint alleges that provisions of Blue Cross's agreements with hospitals raise hospital prices, prevent other insurers from entering the marketplace, and discourage hospital discounts. The challenged provisions are known as most-favored nation (MFN) clauses. The MFNs at issue here are contractual clauses between Blue Cross and hospitals that limit the discounts these hospitals can offer to Blue Cross's competitors.

These MFNs come in two general forms. Blue Cross has existing agreements with 22 hospitals that require the hospital to charge some or all other commercial insurers *more* than the hospital charges Blue Cross, typically by a specified percentage differential. These are "MFN-plus" agreements. In addition, Blue Cross has entered into agreements containing MFNs with more than 40 small, community hospitals, which typically are the only hospitals in their communities, requiring the hospitals to charge other commercial health insurers at least as much as they charge Blue Cross. These are "equal-to MFN" agreements. Blue Cross has also entered into equal-to MFNs with some larger hospitals.

[8] Documents associated with this case are available at http://www.justice.gov/atr/cases/bcbsmfn.html. We became aware of the MFN provisions through our review of another matter involving Blue Cross.

We evaluated Blue Cross's MFN agreements under the rule of reason. We concluded that Blue Cross raised its own costs in order to disadvantage its rivals:

> Blue Cross has sought and obtained MFNs in many hospital contracts in exchange for increases in the prices it pays for the hospitals' services. In these instances, Blue Cross has purchased protection from competition by causing hospitals to raise the minimum prices they can charge to Blue Cross' competitors, but in doing so has also increased its own costs. Blue Cross has not sought or used MFNs to lower its own cost of obtaining hospital services.[9]

Blue Cross's use of MFNs in Michigan has been widespread. Blue Cross has used MFNs or similar clauses in its contracts with at least 70 of Michigan's 131 general acute care hospitals, including many major hospitals in the state. Our complaint alleges that Blue Cross's MFNs have likely increased prices for health insurance sold by Blue Cross and its competitors and prices for hospital services paid by insureds and self-insured employers.

Credit-Card Anti-Steering Rules

On October 4th of this year, the Division and the States of Connecticut, Iowa, Maryland, Michigan, Missouri, Ohio, and Texas filed suit against American Express, MasterCard, and Visa.[10] These companies operate the three largest credit and charge card transaction networks in the United States. In 2009, over $1.6 trillion of transaction volume flowed over their networks, and merchants paid more than $35 billion in associated card acceptance fees.

The challenged conduct in this case involves certain rules, policies, and practices ("Merchant Restraints") imposed by these three networks. These Merchant Restraints impede merchants from promoting or encouraging the use of a competing credit or charge card with lower card acceptance fees. These rules prevent merchants from rewarding their customers based on the customers' card choices. Merchants cannot even suggest that their customers use a

---

[9] Complaint, at ¶5.

[10] Documents associated with this case are at http://www.justice.gov/atr/cases/americanexpress.html.

less costly alternative card by posting a sign stating "we prefer" another card or by disclosing a card's acceptance fee. The effect of these Merchant Restraints is to prohibit merchants from fostering competition among credit card networks at the point of sale.

MasterCard and Visa were willing to resolve our concerns at the time of the filing of the complaint. The settlement we negotiated with MasterCard and Visa is now making its way through the Tunney Act approval process.[11] Under the proposed final judgment, MasterCard and Visa must allow merchants to: (a) offer consumers discounts, rebates, or a free or discounted product or service if the consumer uses a particular credit card; (b) express a preference for the use of a particular credit card; (c) promote a particular credit card through posted information or other communications to consumers; and (d) communicate to consumers the cost incurred by the merchant when a consumer uses a particular credit card. Merchants that do not accept American Express may take advantage of this relief immediately. However, while American Express' restraints on merchants are still in place, merchants that accept American Express as well as Visa or MasterCard will not be able to take full advantage of their new options under the proposed settlement. Litigation against American Express remains ongoing, and American Express has expressed its intention to fully litigate this matter.

Some Common Elements

In both the Blue Cross case and the Credit Card case, the Division has focused on companies with significant market power that entered into agreements that disrupt their rivals in transacting with their common trading partners. Both cases challenge vertical agreements aimed at suppressing horizontal competition. In the Blue Cross case, Blue Cross's MFN provisions

[11] The proposed final judgment is available at http://www.justice.gov/atr/cases/f262800/262875 htm.

prevent rival insurance companies from negotiating a better deal (or in some cases even as good a deal) with various hospitals in Michigan. In the Credit Card case, the Merchant Restraints imposed by one network limit merchants from offering discounts to consumers who use credit and charge cards issued by rival networks.

These two cases also demonstrate the Division's commitment to seeking and obtaining tailored remedies. In both cases, we identified and challenged very specific conduct, and we are seeking tailored relief that addresses our competitive concerns. In both cases, our proposed remedies are narrow and allow the parties to proceed with a variety of contractual practices that do not threaten competition.

COMPETITION ADVOCACY

The Division has been very actively involved in competition advocacy efforts covering a wide range of industries and topics, including telecommunications, financial markets, health care, agriculture, and patents. Eugene Kimmelman, Chief Counsel for Competition Policy and Intergovernmental Relations, will discuss our competition advocacy efforts right before lunch. Here, I would like to highlight one case involving competition advocacy where economic analysis was especially central.

Delta/US Airways Slot Swap

In late 2009, Delta and US Airways proposed a permanent exchange of more than 300 takeoff and landing slots at LaGuardia Airport (LGA) and Ronald Reagan Washington National Airport (DCA). These slots represent the rights to more than 150 daily round trips. LGA and DCA are two important, slot-controlled airports. Slot holdings at DCA and LGA are concentrated in the hands of the so-called “legacy carriers”, principally US Airways and Delta.[12] The transaction would have increased US Airways’ share of slots at DCA from 44% to 54% and Delta’s share at LGA from 24% to 49%.

The parties sought a waiver from a Federal Aviation Administration (FAA) order that prohibited the permanent transfer of LaGuardia slots. Under FAA regulations, it may grant a waiver if it finds the transfer to be “in the public interest.” The Division filed formal comments on this matter with the Department of Transportation (DOT).[13] The Division supported the proposed DOT Order that would permit the slot transfers, subject to the condition that the carriers dispose of 14 pairs of slot interests at DCA and 20 pairs of slot interests at LGA to “eligible new entrant and limited incumbent carriers.” We also offered recommendations on the appropriate means for divesting these slots.

A key competitive concern was that the transaction would have reduced competition between Delta and US Airways on a number of routes at DCA and LGA, thereby harming consumers. In addition to serving their hubs and major focus cities, which is what other incumbent carriers at these airports do almost exclusively, Delta and US Airways also compete against one another in a number of “non-core” routes, and they are one another’s most likely potential competitors on numerous routes at DCA and LGA. Much of this actual and potential competition between Delta and US Airways would have been lost as a result of the transaction.

---

[12] Legacy carriers are incumbents that have been operating since before the deregulation of the airline industry in the late 1970s and early 1980s. These carriers tend to employ a hub-and-spoke system of flights.

[13] *See*, Public Comments to the FAA. *Notice of Petition for Waiver of the Terms of the Order Limiting Scheduled Operations at LaGuardia Airport and Solicitation of Comments on the Grant of Petition with Conditions* (http://www.justice.gov/atr/public/comments/257463.pdf).

The Division further concluded that the parties' transaction, as originally proposed, would have made low cost carrier (LCC) entry at the affected airports less likely, thereby depriving consumers of the lower fares that vigorous competition from LCCs would generate. Empirical work by Division economists suggested that the presence of an LCC on a non-stop route reduces fares by roughly 25%. This is consistent with an extensive economic literature that shows the large effect of LCCs on fares, relative to effects caused by other classes of carriers. Our empirical work also suggested that airports with higher LCC penetration have much lower fares.

Furthermore, the evidence indicates that incumbent carriers with a large airport presence hoard slots and use them sub-optimally, in part to keep them out of the hands of new entrants. As discussed in greater detail in our formal comments, there are a variety of commercial disincentives for such incumbents to sell or lease slots, and there are multiple ways by which these incumbents have resisted regulatory efforts to foster efficient slot allocation and usage. For example, while the FAA imposes a "use or lose" requirement for some slots, which mandates that they be used at least 80% of the time over a two-month period, this rule does not in practice translate into slot usage patterns that replicate the outcome of competition. Incumbents instead tend to fly excessive frequencies (which increases slot utilization) with small planes (which limits capacity while still "using" the slot). In particular, we found that US Airways and Delta operate significantly smaller aircraft at LGA and DCA than do the airlines eligible to purchase the divested slots. Assets are used in less-efficient, less pro-consumer ways than would result from greater entry and competition. The proposed swap, relative to likely alternative scenarios, would have harmed consumers by making procompetitive reallocations and usage patterns significantly less likely.

Turning to remedy, the evidence suggested that the relatively modest slot divestiture proposed by the FAA was unlikely to interfere substantially with the procompetitive benefits the parties sought to obtain from the swap. As to the appropriate means for divesting slots, the Division recommended an option that would limit the carriers deemed eligible to purchase the divested slots while preserving the anonymity of potential buyers. Anonymity makes it more difficult for the divesting carriers to disfavor the acquirers most likely to compete with them. The DOT subsequently issued an order calling for slot divestitures along the lines of the Division's recommendation.[14] The parties were unwilling to make these divestitures and have challenged the FAA's order in court.

As a postscript on this matter, subsequent events seem to have confirmed the Division's concerns. After DOT issued its order, US Airways announced new and expanded service on several routes out of LGA.[15] Similarly, Delta announced increased service at LGA and DCA.[16] This is just the type of competition that the Division feared would be lost with the transaction.

MERGER ENFORCEMENT

Table 2 above displays the Division's merger enforcement data for the past five fiscal years. As many of you well know, merger activity was unusually low during Fiscal Year 2009 in

---

[14] *See* Department of Transportation Final Decision, *Notice on Petition for Waiver of the Terms of the Order Limiting Scheduled Operations at LaGuardia Airport* (http://www regulations.gov/search/Regs/home.html#documentDetail?R=0900006480aeb0a5).

[15] *See* Press Release, *US Airways Bolsters Flying to the Big Apple: Airline Introduces New Service from Seven Cities and Expanding Service from Three Others to New York's LaGuardia Airport* (Aug 16, 2010), available at http://phx.corporate-ir.net/phoenix.zhtml?c=196799&p=irol-newsArticle_print&ID=1460124&highlight.

[16] *See* Press Release, *Delta Enhancing Domestic Schedules in Key East Coast Business Markets Customers in 21 cities*: *gain increased service to New York or Washington D.C.* (Jul 28, 2010), available at http://news.delta.com/index.php?s=43&item=1088.

the wake of the financial crisis. HSR filings for Fiscal Year 2009 were down to 716, about one-third of their level of 2,201 during Fiscal Year 2007. Data for Fiscal Year 2010 were recently compiled. They show roughly a 50% increase in HSR filings from Fiscal Year 2009, up to 1,170. In keeping with historical norms, 1.9% of HSR filings resulted in a DOJ Second Request. During 2010, the Division challenged 19 mergers, including 10 filed merger cases.

Horizontal Merger Guidelines

These meetings are an opportune time to discuss the 2010 Horizontal Merger Guidelines, which were issued just three months ago.[17] In fact, in the very next session you will hear from the DOJ and FTC about the revised Guidelines (and about the review of consummated mergers). The Antitrust Division will be represented by me and by Maribeth Petrizzi, Chief of the Division's Litigation II Section. Before we get to that session, however, I would like to respond to some of the comments that the DOJ and FTC received in June in response to the proposed Guidelines that were made public in April, and to some of the commentary I have seen and heard since the Guidelines were issued in August. My talk today complements a longer paper of mine that will be coming out very soon in the *Antitrust Law Journal*.[18] That paper puts the 2010 Guidelines in historical context and explains a number of the economic principles underlying the Guidelines.

The revised Guidelines are the product of an extensive team effort at the Agencies that took place over roughly a year, under the leadership of Assistant Attorney General Christine Varney and FTC Chairman Jon Leibowitz. The process for revising the Guidelines was lengthy,

[17] The revised Horizontal Merger Guidelines were issued on August 19, 2010. They are available at http://www.justice.gov/atr/public/guidelines/hmg-2010 html.

[18] Carl Shapiro, "The 2010 Horizontal Merger Guidelines: From Hedgehog to Fox in Forty Years," 77 *Antitrust Law Journal*, available at http://www.justice.gov/atr/public/articles/263528.pdf.

collaborative, and far more open than any previous revision. In April, the FTC made public a draft of the proposed Guidelines, public comments were invited, and numerous changes were made in response to those comments.

From the outset, a primary motivation in revising the Guidelines was to promote transparency by describing more accurately how the Agencies actually evaluate horizontal mergers. Now that the revised Guidelines have been issued, and several months have passed, there is a broad consensus that they do accurately describe how the Agencies analyze horizontal mergers. This is by design: the revision process involved extensive consultation with career staff at both Agencies who are intimately familiar with Agency practice. Nonetheless, three months out, it is helpful to hear experienced antitrust lawyers and economists agree that Agency practice is accurately reflected in the revised Guidelines. People may differ in how they think we *should* review horizontal mergers, but hopefully we can all agree that the Guidelines should accurately describe how we *actually do* review them.

As we revised the Guidelines, we were quite conscious that they are read by several distinct audiences. First and foremost, the Guidelines are intended to inform the business community and antitrust practitioners of the "principal analytical techniques, practices, and the enforcement policy" of the Agencies.[19] We felt it was important to update the Guidelines to reflect changes in Agency practice that had taken place since the last major revision of the Guidelines in 1992.

Second, the Guidelines "may also assist the courts in developing an appropriate framework for interpreting and applying the antitrust laws in the horizontal merger context."[20]

---

[19] See Horizontal Merger Guidelines, §1.

[20] *Id.*

As we revised the Guidelines, we were cognizant of the virtues of explaining not just *how* the Agencies evaluate mergers, but *why* we employ the techniques described in the 2010 Guidelines, almost all of which were also in the 1992 Guidelines.

Third, the Guidelines serve as a valuable resource for the Agencies themselves. Clear and up-to-date Guidelines help ensure consistency in Agency review and provide discipline to the merger review process. In revising the Guidelines, we worked closely with the staff at both Agencies to ensure that the revised Guidelines not only reflect Agency practice but provide a durable framework to guide staff as they conduct merger investigations.

Last, but certainly not least, the Guidelines explain to other jurisdictions how we in the United States evaluate mergers. By stating clearly how the U.S. evaluates horizontal mergers, the revised Guidelines should promote convergence and facilitate the sharing of best practices across jurisdictions. To this end, as we worked on the Guidelines over this past year, we paid close attention to the merger guidelines of other jurisdictions. We also received input from a number of international agencies. We hope that the practice of making draft Guidelines available for public comment will become the norm internationally. Rachel Brandenburger, Special Advisor, International, will be speaking more generally about international competition and cooperation issues on the final panel this afternoon.

Market Definition and Market Concentration

One concern I have heard is that the revised Guidelines fail to place sufficient weight on market definition. I believe this concern is not well-founded. For starters, the revised Guidelines devote nearly 12 pages to product and geographic market definition, in comparison with just five pages in the 1992 Guidelines. More importantly, Section 4 of the Guidelines begins:

> When the Agencies identify a potential competitive concern with a horizontal merger, market definition plays two roles. First, market definition helps specify the line of commerce and section

> of the country in which the competitive concern arises. In any merger enforcement action, the Agencies will normally identify one or more relevant markets in which the merger may substantially lessen competition. Second, market definition allows the Agencies to identify market participants and measure market shares and market concentration.

The Division recognizes the necessity of defining a relevant market as part of any merger challenge we bring. Criticism of the revised Guidelines suggesting otherwise is off the mark. It is true that we often do not *start* our merger investigations with market definition. However, that is no surprise to experienced practitioners, and that point was made quite explicitly in the 2006 Commentary of the Horizontal Merger Guidelines.[21]

The revised Guidelines *do* somewhat downplay the role of market *concentration*, *e.g.*, by devoting more space to the discussion of other types of evidence to assess competitive effects and by emphasizing that the Agencies often rely on more direct types of evidence, rather than market shares and market concentration, to predict competitive effects. That is why the passage quoted just above continues: “The measurement of market shares and market concentration is not an end in itself, but is useful to the extent it illuminates the merger’s likely competitive effects.”

So far as I can tell, there is a rather broad consensus about the desirability of supplementing evidence about market structure – *i.e.*, measurements of the level and change in market concentration – with other forms of evidence that “tell the story” of competitive effects. The revised Guidelines acknowledge that the Agencies have moved in that direction over the past 18 years, a journey they have taken with the courts.

Another line of criticism suggests that the revised Guidelines endorse narrower markets than had their predecessors. However, the 2010 Guidelines employ the same basic “hypothetical monopolist test” that has been in the Guidelines since 1982. It is true that the 2010 Guidelines

[21] United States Department of Justice and Federal Trade Commission, Commentary on the Horizontal Merger Guidelines, Mar. 2006, available at http://www.justice.gov/atr/public/guidelines/215247 htm

explain in more detail the *implementation* of the hypothetical monopolist test, but the 2010 Guidelines do not alter the basic test. If anything, the Guidelines now are open to *broader* markets, since the "smallest market principle" has been relaxed.[22] Anyone who is startled at how the logic of the test works might usefully consult with an economist and/or refer to the 2006 Commentary, which explained that the test typically leads to markets that exclude some products to which some customer would indeed turn in response to a price increase. Section 4.1.1 of the Guidelines states: "The Agencies use the hypothetical monopolist test to identify a set of products that are reasonably interchangeable with a product sold by one of the merging firms." The test is designed to include in the market *reasonable* substitutes, not *all* substitutes.

Flexibility and Predictability

Another set of comments revolves around the concern that the revised Guidelines make it more difficult for businesses to predict how the Agencies will evaluate proposed mergers. This is an important issue: merger enforcement necessarily involves a tradeoff between predictability and accuracy, and it is highly desirable for guidelines to articulate practices that are as predictable as possible without sacrificing accuracy. I have several responses to this concern.

First, the revised Guidelines, by increasing transparency and providing more up-to-date guidance, should allow the business community to assess more accurately how the Agencies are likely to evaluate proposed horizontal mergers. As emphasized in the 2006 Commentary, the Agencies have, for years, employed a variety of approaches, depending upon the facts of the specific merger. Providing a more accurate and transparent description of Agency practice in the Guidelines may well *indicate* the presence of uncertainty, but it cannot *add* to uncertainty.

[22] See Horizontal Merger Guidelines, §4.1.1.

Second, the supposed simplicity and predictability in the 1992 Guidelines, based on market definition and market concentration, was more apparent than real. Market definition is often disputed, especially in cases involving differentiated products, as one can see by looking at the litigated merger cases over the past decade. As the strength of the structural presumption has declined, often due to arguments by merging parties that the level and change in market concentration are not reliable guides to competitive effects, the role of simple bright-line rules based on HHIs has declined as well. The 2010 Guidelines reflect that trend.

Third, and closely related, some observers appear to believe that the revised Guidelines have abandoned the HHI "safe harbors" in cases involving unilateral effects.[23] This misperception seems to have arisen because some methods of evaluating unilateral effects are not based on market definition or market concentration. In fact, Section 5.3 of the 2010 Guidelines expands the concentration-based "safe harbors" by raising the HHI thresholds.

> The Agencies employ the following general standards for the relevant markets they have defined:
> *Small Change in Concentration:* Mergers involving an increase in the HHI of less than 100 points are unlikely to have adverse competitive effects and ordinarily require no further analysis.
> *Unconcentrated Markets:* Mergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and ordinarily require no further analysis.

Figure 1 shows the HHI thresholds under the 1992 Guidelines. The 1992 Guidelines had a peculiar feature that undermined predictability: with a post-merger HHI near 1,800 and a change in the HHI of near 100, slight changes in the data leading to a slightly different level or change in the HHI could generate a green, yellow, or red signal.

---

[23] I use the term "safe harbor" to mean exactly what the Guidelines themselves say about mergers falling into these HHI zones: these mergers "are unlikely to have adverse competitive effects and ordinarily require no further analysis." Horizontal Merger Guidelines, Section 5.3.

Figure 1: HHI Thresholds Under the 1992 Guidelines

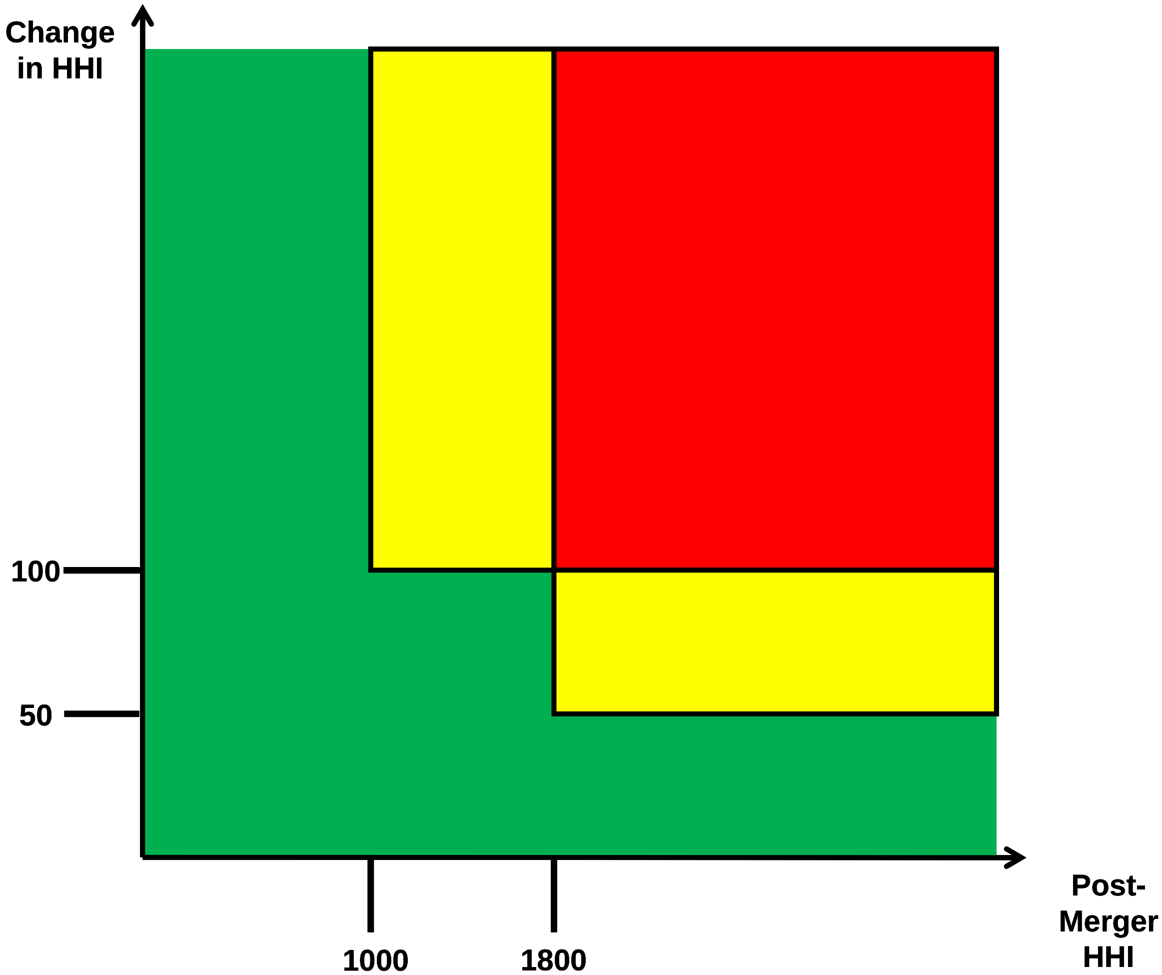


Figure 2 shows the HHI thresholds under the 2010 Guidelines. In addition to raising the HHI thresholds, the 2010 Guidelines eliminated the glitch in the 1992 Guidelines. The green zone keeps a safe distance away from the red zone.

Figure 2: HHI Thresholds Under the 2010 Guidelines

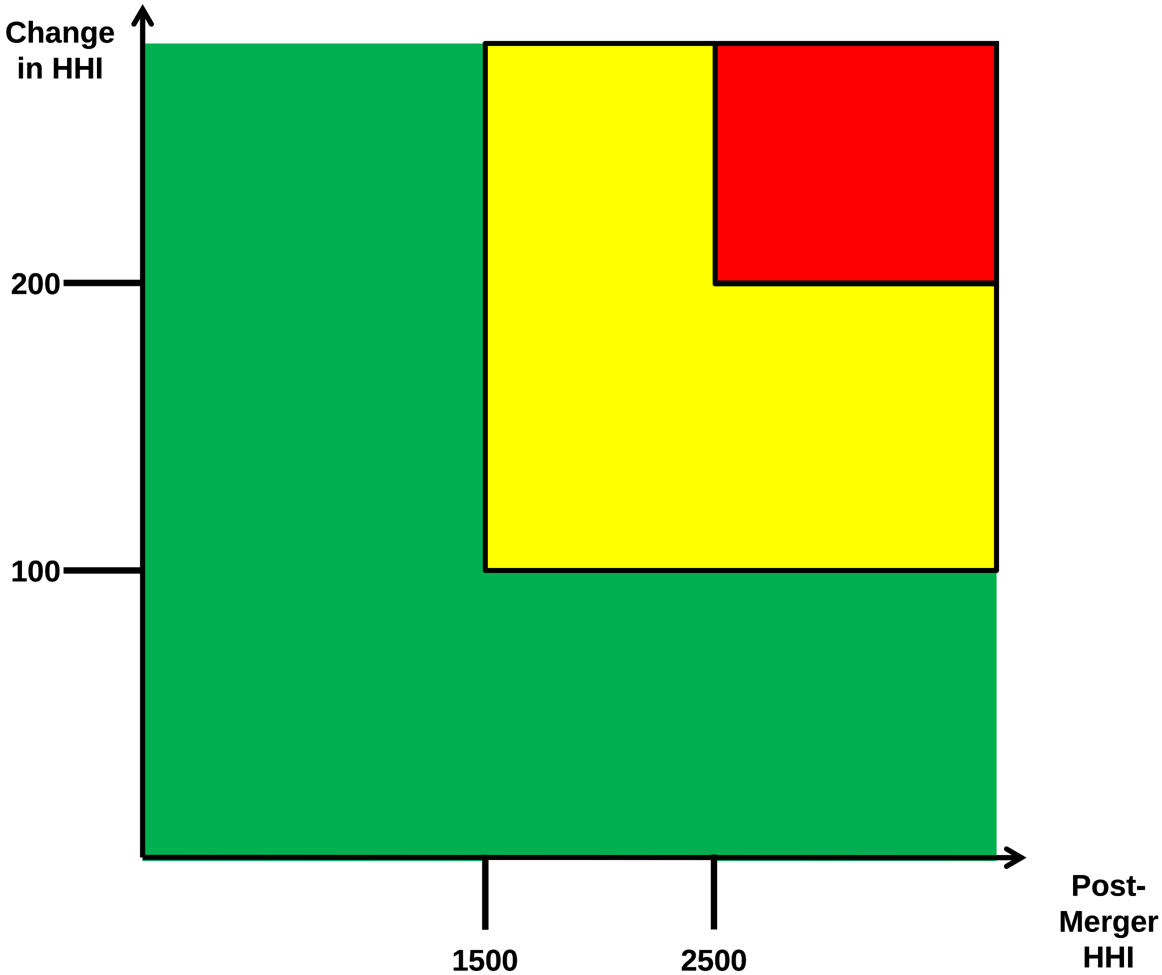
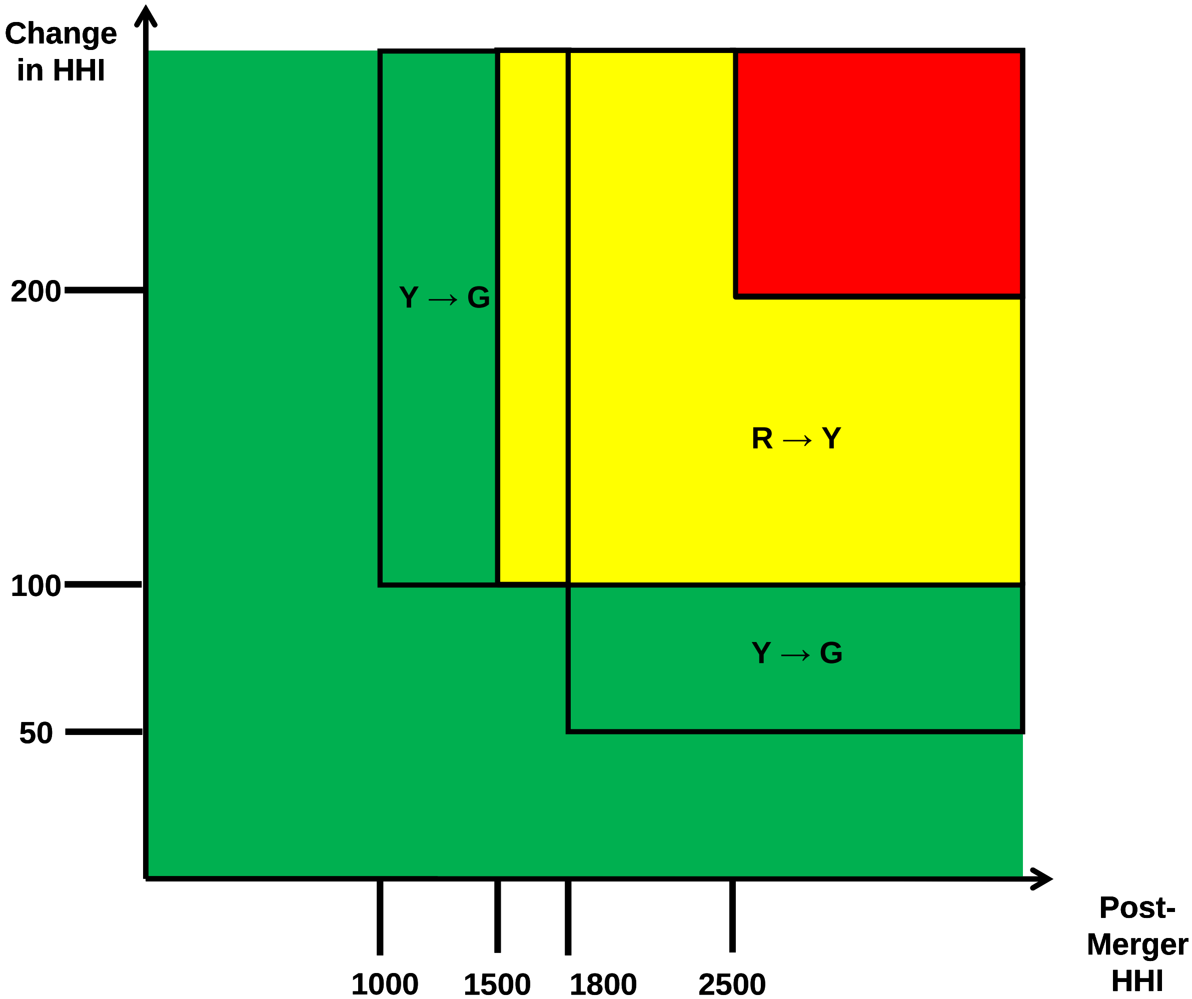


Figure 3 shows the change from the 1992 Guidelines to the 2010 Guidelines. Most of the yellow zone shifted to green, and a good chunk of the red zone shifted to yellow.

Figure 3: Change from 1992 to 2010



Fourth, and perhaps most important for the purposes of M&A planning, it is worth remembering that the vast majority of proposed mergers are cleared promptly without a second request. The merger enforcement statistics show that less than 5% of HSR filings lead to second requests.[24] For those relatively few deals where the Agencies conduct a thorough investigation,

---

[24] During the ten-year period from Fiscal Year 1999 through Fiscal Year 2008, the percentage of all HSR transactions involving a second request varied annually from a low of 2.1% to a high of 4.3%. See DOJ and FTC Hart-Scott-Rodino Annual Report, Fiscal Year 2008, available at http://www ftc.gov/os/2009/07/hsrreport.pdf.

experienced practitioners already know that "investigations are intensively fact-driven iterative processes."[25]

The Use of Price/Cost Margins

In response to the draft Guidelines that were made public in April, a number of commentators raised concerns about their use of price/cost margins. The Guidelines were revised in several ways to address these concerns – *e.g.*, to clarify that high margins are not themselves of antitrust concern – that high margins commonly arise for products that are significantly differentiated, and that high margins can be consistent with incumbent firms earning competitive returns. As an economist with 30 years experience dealing with antitrust issues, I regard these statements as self-evident. But I certainly am glad that we made a draft of the Guidelines available for public comment so we could clarify these points before finalizing the Guidelines.

Despite these clarifications, some questions about the role of price/cost margins in the Guidelines have persisted. My *Antitrust Law Journal* paper explains in considerable detail how margins are used in the Guidelines, and I will not repeat that entire discussion here. I will point out, however, that in any discussion of the pricing incentives of profit-maximizing firms, price/cost margins *must* play a central role. The 2010 Guidelines do not change the role of price/cost margins in the hypothetical monopolist test used for market definition.[26] They do point out a well-known flaw in certain methods of performing critical loss analysis and warn merging parties that analysis based on this flaw will not be persuasive to the Agencies. The

[25] *See* 2006 Commentary on the Horizontal Merger Guidelines, p. 3.

[26] Price/cost margins are also central to the "vertical arithmetic" that arises in vertical merger cases when evaluating the incentives of the merged entity to foreclose rivals. These techniques have also been used by the Agencies and for many years, *e.g.*, in telecommunications mergers involving content and distribution.

Agencies have been aware of this flaw for roughly a decade, if not more, and calling out the flaw promotes transparency.

Some observers have questioned the statement that when a profit-maximizing firm sets its price well above marginal cost, this normally implies that the firm does not believe its customers are highly sensitive to price. However, this is nothing more than a recitation of the standard pricing rule that can be found in economics textbooks.[27] In practice, the Agencies realize that measuring incremental cost can be challenging. More fundamentally, the Agencies' analysis of demand conditions does not stop with simple textbook rules. While price/cost margins can be very informative about the elasticity of demand facing a single firm, the Agencies routinely look for additional evidence regarding the elasticity of demand, especially qualitative or quantitative evidence showing how customers have responded historically to changes in relative prices.[28] Furthermore, evidence regarding demand conditions typically is used in conjunction with evidence regarding supply-side conditions, *e.g.*, the ease or difficulty of repositioning and entry.

Unilateral Price Effects and Upward Pricing Pressure

Most of the Division's cases in recent years have involved unilateral effects. The 2010 Guidelines significantly expand the discussion of unilateral effects. Section 6.1 brings up to date the discussion of unilateral price effects with differentiated products. A good part of my

---

[27] In textbooks, this rule is usually explained as "marginal revenue equals marginal cost," or "MR=MC." In antitrust circles, this same relationship is more commonly known as the Lerner Equation, (P-MC)/P=1/E, where P is price, MC is marginal cost, and E is the elasticity of demand. As with any simple rule, the Agencies are well-aware that the Lerner Equation must be modified to fit the circumstances, *e.g.*, to account for substitutes products sold by the firm in question and/or anticipated reactions by rivals. The Lerner Equation is an extremely widely recognized and used starting point for analyzing pricing incentives.

[28] We also consider how customers have responded to changes in non-price terms and conditions, such as changes in product quality or service.

Antitrust Law Journal paper is devoted to unilateral effects. Here I touch on a few points where questions have been raised about this section of the Guidelines.

Some critics express concern about the lack of a "safe harbor" for cases involving unilateral price effects, lamenting the loss of the "35% safe harbor" in the 1992 Guidelines. These critics have it exactly backwards.

First, there was no such "safe harbor," as the 2006 Commentary makes very clear: "Section 2.2 of the Guidelines does not establish a special safe harbor applicable to the Agencies' consideration of possible unilateral effects."[29] To the contrary, if the combined share of the merging parties exceeded 35%, there was a *presumption* operating against the merging parties, namely that "a significant share of sales in the market are accounted for by consumers who regard the products of the merging firms as their first and second choices."[30]

Second, the 2010 Guidelines expand the HHI-based "safe harbors" that apply to all cases, not just those involving unilateral price effects for differentiated products. "Mergers involving an increase in the HHI of less than 100 points are unlikely to have adverse competitive effects and ordinarily require no further analysis."[31] A merger between firms with market shares of 5% and 10% (just) fits into this "safe harbor." The corresponding figure in the 1992 Guidelines was a change in the HHI of 50 points, which would (just) cover a merger between two firms with market shares of 5%.

Third, the 2010 Guidelines, for the first time, point the way towards a "safe harbor" applicable to unilateral price effects with differentiated products. Section 6.1 states:

---

[29] *See* the 2006 Commentary on the Horizontal Merger Guidelines, p. 26.

[30] *See* the 1992 Horizontal Merger Guidelines, §2.211. This presumption only applied if market shares were reasonable proxies for diversion ratios.

[31] *See* the Horizontal Merger Guidelines, §5.3.

> "If the value of diverted sales is proportionately small, significant unilateral price effects are unlikely. For this purpose, the value of diverted sales is measured in proportion to the lost revenues attributable to the reduction in unit sales resulting from the price increase. Those lost revenues equal the reduction in the number of units sold of that product multiplied by that product's price."

My *Antitrust Law Journal* article explains that the value of diverted sales measured in proportion to these lost revenues is equal to the gross upward pricing pressure index, or GUPPI.[32]

What does all this imply for "safe harbors"? The 2010 Guidelines state that unilateral price effects for differentiated products are unlikely if the GUPPI is small. Since 1982, under the Guidelines a "small but significant increase in price" has usually corresponded to a 5% increase in price. Current Division practice is to treat the value of diverted sales as proportionately small if it is no more than 5% of the lost revenues.[33] Put differently, unilateral price effects for a given product are unlikely if the gross upward pricing pressure index for that product is less than 5%. If each firm sells one product, and the prices of the two products are equal, this index is equal to the multiplicative product of the diversion ratio and the margin. For example, if the diversion ratio is 20% and the margin is 20%, the index is 20% times 20% or 4%, which falls into the "safe

[32] The GUPPI is defined as $D_{12} \times M_2 \times \frac{P_2}{P_1}$, where D_{12} is the diversion ratio from Product 1 to Product 2, $M_2 = (P_2 - C_2)/P_2$ is the relative margin on Product 2, and P_1 and P_2 are the prices of the two products. This measure is an index of upward pricing pressure, *not* a prediction of the magnitude of any post-merger price increase. This significant distinction is explained much more fully in my *Antitrust Law Journal* article.

[33] This statement applies to the analysis based on the value of diverted sales, as described in Section 6.1, Pricing of Differentiated Products. That Section 6.1 does not apply to cases in which the merging firms sell relatively homogeneous products. In markets with relatively homogeneous products, diversion ratios can be very high and margins quite low in the absence of any coordination. Section 6.3, Capacity and Output for Homogeneous Products, tends to be more relevant to the analysis of unilateral effects in such cases. Section 7, Coordinated Effects, may also be applicable.

harbor."[34] The "safe harbor" outlined here does not indicate any tolerance for anti-competitive price increases. Rather, it reflects the fact that a small amount of upward pricing pressure is unlikely, at the end of the day, to correspond to any actual post-merger price increase.

Others have expressed concern that the presence of price/cost margins in the "value of diverted sales" measure is somehow biased against industries with high margins. It is not. The basic logic of unilateral pricing effects has always revolved around diversion of sales from Product 1, sold by one merging firm, to Product 2, sold by the other merging firm. Diverting sales to Product 2 only affects the merged firm's profits to the extent that those sales will contribute to profits, *i.e.*, to the extent that price exceeds marginal cost for Product 2. This is just arithmetic.[35]

As with any analysis based on prices, marginal costs, and demand elasticities, this whole approach is focused on the demand side, taking as given the set of products offered. In many cases, especially in high-tech mergers, the set of products can change quite rapidly, so it is important to consider the introduction of new products, which can dramatically alter both the margins on existing products and diversion among them. In other cases, where innovation may not be especially important but new products are regularly introduced, repositioning can be important. The point is that analysis of upward pricing pressure (and its more elaborate cousin, merger simulation), which has gotten a lot of attention of late, is a demand-side analysis of economic incentives involving prices, costs, and quantities. (The same is true of the hypothetical

[34] My *Antitrust Law Journal* article explains the relationship between the gross upward pricing pressure index and market definition. If customers are equally sensitive to price increases and price decreases, an index of at least ten percent implies that the two firms' products alone satisfy the hypothetical monopolist test.

[35] Some mistakenly believe that the appearance of the margin on Product 2 in the value of diverted sales measure reflects an assumption about the relationship between the margin on Product 2 and the elasticity of demand for Product 2. No such assumption is required for the arithmetic to operate as described above.

monopolist test). While this analysis can be highly informative, the Agencies understand full well that measuring upward pricing pressure, or even performing a full merger simulation, typically is not the end of the story, especially in rapidly changing industries. Repositioning, entry, innovation, and efficiencies must also be considered.

Coordinated Effects

The 2010 Guidelines have not changed the basic definition of coordinated interaction. "Coordinated interaction involves conduct by multiple firms that is profitable for each of them only as a result of the accommodating reactions of the others."[36] However, the 2010 Guidelines now include "parallel accommodating conduct" as a form of coordinated interaction.

> Coordinated interaction alternatively can involve parallel accommodating conduct not pursuant to a prior understanding. Parallel accommodating conduct includes situations in which each rival's response to competitive moves made by others is individually rational, and not motivated by retaliation or deterrence nor intended to sustain an agreed-upon market outcome, but nevertheless emboldens price increases and weakens competitive incentives to reduce prices or offer customers better terms.[37]

Let me explain why parallel accommodating conduct is now included as a form of coordinated interaction, and what this is likely to mean in practice.

A simple but central example of parallel accommodating conduct may be useful at this point. Consider a four-to-three merger in a market for a relatively homogeneous product, in which customers display little brand loyalty, and low costs of switching suppliers. The post-merger HHI is above 2,500 and the change in HHI is above 200, so the structural presumption from Section 5.3 of the Guidelines applies. Since many customers would switch between

---

[36] *See* Horizontal Merger Guidelines, Section 7. A virtually identical definition of coordinated interaction can be found in Section 2.1 of the 1992 Guidelines.

[37] *Id.* The 2006 Commentary (p.18) noted that successful coordination "typically" – but not always – involves reaching an agreement, detecting deviations from that agreement, and punishing those deviations.

suppliers in response to small differences in their prices, a unilateral price increase by the merged firm would not be profitable if the prices charged by its two rivals do not also rise. The evidence indicates that the merger likely will enable the merged firm to become the industry price leader. In particular, the merged firm's two rivals will likely follow price increases that it initiates.

This pattern of behavior does not involve any agreement by the other two firms to be followers; doing so is in their own best interest. This pattern of behavior does not involve any agreement that the merged firm will punish the other two firms if they fail to follow; but all three firms know that the merged firm will likely rescind its price increase in that event. Thus, the anticipated pricing behavior does not involve reaching and enforcing an agreement, central elements of the explicit and tacit collusion, the two other forms of coordinated interaction.

The 2010 Guidelines expand the category of coordinated interaction, but they do not create a new type of adverse competitive effect that the Agencies were unable to challenge under the 1992 Guidelines. The price leadership scenario just described might also be challenged under a theory of unilateral effects, which can include accommodating responses by rivals.[38] Whether parallel accommodating conduct is counted as a form of "coordinated effects," or as a form of "unilateral effects," is a labeling issue. As the 2010 Guidelines explicitly note, there is no sharp distinction between unilateral effects and coordinated effects. Section 1 states:

> A merger can enhance market power simply by eliminating competition between the merging parties. This effect can arise even if the merger causes no changes in the way other firms behave. Adverse competitive effects arising in this manner are referred to as "unilateral effects." A merger also can enhance market power by increasing the risk of coordinated, accommodating, or interdependent behavior among rivals. Adverse competitive effects arising in this manner are

[38] Section 6.1in the Guidelines notes that models of unilateral effects "often include independent price responses by non-merging firms." This is not a change in practice. The economic models of unilateral effects used by the Agencies have long included such responses.

> referred to as "coordinated effects." In any given case, either or both types of effects may be present, and the distinction between them may be blurred.

Hopefully we can all agree that a merger can substantially lessen competition by enabling parallel accommodating conduct, such as price leadership, whatever label is attached to such conduct.

The Worldcom/Sprint merger, which the Division challenged in 2000, is one example of a merger in which parallel accommodating conduct was of concern to the Division. The Division's concerns did not hinge on whether this conduct was classified as a form of "unilateral effects" or as a form of "coordinated effects."[39] The Complaint stated:

> The merger will also facilitate coordinated or collusive pricing or other anticompetitive behavior by the merged entity and AT&T. If the merger is consummated, AT&T and WorldCom/Sprint will collectively control approximately 80% of the market, while their next largest competitor will have a market share of no more than 3%.[40]

The Division alleged a relevant market for mass-market long-distance telecommunications services. In that market, Worldcom and Sprint were two of the "Big 3" firms, with shares of about 19% and 8% respectively. The post-merger HHI was about 3800, and the change in the HHI resulting from the merger was about 300. The fact that a single non-merging rival, AT&T, had a market share of over 50% was highly relevant. As noted explicitly in the 2010 Guidelines, the concentration among non-merging parties (and thus the level of the HHI) is much more relevant for coordinated effects than for unilateral effects.

---

[39] The Division's complaint is available at http://www.justice.gov/atr/cases/f5000/5051 htm.

[40] *Id.* at ¶69.

The Alcan/Pechiney merger, which the Division challenged in 2003, provides another example of Division concerns about parallel accommodating conduct.[41] The Division alleged a relevant market for brazing sheet, an aluminum alloy used in making heat exchangers for motor vehicles. After the proposed acquisition, the combined firm and the largest U.S. producer of brazing sheet would have commanded over 80% of all brazing sheet sales in North America. The post-merger HHI would have been over 3,600, with an increase in the HHI of more than 600. The Complaint (¶22) states:

> The proposed transaction will make it more likely that the few remaining brazing sheet producers will engage in anticompetitive coordination to increase prices, reduce quality and innovation, and decrease production of brazing sheet. After the acquisition, the combined firm and its largest North American rival would share market leadership and a common incentive to pursue strategies that emphasize accommodation and do not risk provocation.

Dynamic Competition and Innovation

Many observers over the years have expressed concerns that the 1992 Guidelines paid insufficient attention to innovation, especially since innovation effects figure prominently in many investigations and Agency enforcement actions. We consider innovation to have paramount importance for antitrust. Economic research going back to Robert Solow's work in the 1950s has shown that the increasing standards of living enjoyed in America during the 20th century were largely a result of technological advances. In the realm of merger review, effects on innovation ultimately can be far more important than short-term pricing effects.

Precisely because innovation is so important, we look carefully to identify and challenge mergers likely to discourage or retard innovation. In drafting the revised Guidelines, we considered it important to address innovation in much more detail so as to give more guidance regarding the basic theories of harm to innovation that the Agencies most often consider. I

[41] Documents associated with this case are available at http://www.justice.gov/atr/cases/alcan0.htm.

believe we have achieved that goal, even though some observers would have liked even more language to stress the importance of innovation. Section 6.4 in the 2010 Guidelines explains how we evaluate innovation effects. Section 10, on efficiencies, was also updated to make clear that the Agencies consider efficiencies that spur the development of new products.

Selected Recent Merger Cases

Let me now turn to discuss two recent merger cases and how our analysis in these cases relates to the principles articulated in the revised Guidelines.

United Airlines/Continental Airlines

Let me start with our investigation into the proposed merger of UAL Corporation with Continental Airlines, Inc.[42] The UAL/Continental merger, while combining their largely complementary networks, raised the Division's concerns regarding a number of routes where United and Continental had offered competing nonstop service. The largest overlap routes were between United's hub airports and Continental's hub at Newark airport. Our competitive concerns regarding the Newark overlaps were heightened because Continental had a high share of service at Newark where there is limited availability of taking and landing slots at Newark, making entry by other airlines particularly difficult. After the Division raised these concerns, the parties agreed to transfer 36 Newark slots to Southwest, a low-cost carrier that had limited service into the New York metropolitan area and zero presence at Newark. This prompt resolution of the Division's competitive concerns was reached for the benefit of consumers but without creating obstacles to a transaction that was otherwise lawful under the antitrust laws.

---

[42] Press Release, *United Airlines and Continental Airlines Transfer Assets to Southwest Airlines in Response to Department of Justice's Antitrust Concerns* (Aug. 27, 2010), available at http://www.justice.gov/atr/public/press_releases/2010/262002.htm.

Baker Hughes/BJ Services

On April 27th, the Division filed a complaint challenging the proposed merger of Baker Hughes Incorporated (Baker Hughes) and BJ Services Company (BJ Services). At the same time, we filed a proposed settlement requiring divestitures and other terms and conditions sufficient to eliminate our concerns over the competitive effects of the merger.[43]

Baker Hughes and BJ Services are two of only four companies that operate specially equipped vessels that provide oil and gas companies with pumping services (Vessel Stimulation Services) in the U.S. Gulf of Mexico. These Vessel Stimulation Services are used in the vast majority of offshore wells in the Gulf. Our investigation confirmed that the provision of Vessel Stimulation Services in the Gulf constituted a relevant product market because oil and gas customers would not markedly reduce their consumption of this service – which represented only a small fraction of their total cost of production – in response to even a significant increase in its price. Further, because suppliers can readily price their services differently as a function of the location of the job, services provided in the Gulf comprised the relevant geographic component of the market. This case illustrates how the Division applies some of the concepts described in Sections 6.1 and 6.2 of the revised Guidelines.

We concluded that the merging parties earned substantial price-variable cost margins on their provision of Vessel Stimulation Services. Therefore, merely as a matter of arithmetic, a unilateral attempt by the merged firm to raise price by a small amount would be unprofitable even if only a relatively small fraction of these sales would be lost. One key issue, therefore, was whether the fraction of sales likely to be lost would be at least that large. A closely related

[43] Documents associated with this case are available online at http://www.justice.gov/atr/cases/baker htm. The discussion here relies heavily on Heyer and Shapiro, *op. cit.*

issue was the extent to which the sales lost by one of the merging firms from raising its pre-merger price would be recaptured as greater business by the other merging firm. Absent any such internalization of lost sales, there would be no difference between the incentive for the merged firm unilaterally to raise price post-merger and the incentives of the individual firms to do so pre-merger.

Our investigation showed that Baker Hughes and BJ Services were close competitors. During the past two years they ranked first and second in terms of total expenditures on Vessel Stimulation Services by many customers, and they shared many of the same characteristics. For similar types of jobs they charged similar prices, operated in the same water depths, and served customers at many of the same geological locations. This suggested that their services, while differentiated, were relatively close substitutes for one another. Combined with the fact that only two other firms competed in the market and demand was highly inelastic, this evidence led us to conclude that the diversion ratios between the services offered by the two firms were significant.

Together with the relatively high pre-merger margins, this led us to conclude that the merger would generate significant upward pricing pressure on the services offered by the two firms. More specifically, we determined that the gross upward pricing pressure index for the services offered by the two firms was substantial. Further investigation showed that our competitive concerns in the Vessel Stimulation Services market were not inextricably linked to the realization of significant merger-specific efficiencies. We also concluded that neither entry, the threat of entry, nor repositioning would likely prevent a post-merger exercise of greater market power.

******

There have been other instances where the Division's merger review has led parties to abandon an anticompetitive transaction. For example, Blue Cross-Blue Shield of Michigan had proposed to purchase Physicians Health Plan of Mid-Michigan, which would have given Blue Cross control of nearly 90% of the commercial health insurance market in the Lansing, Michigan area and resulted in higher prices, fewer choices, and a reduction in the quality of commercial health insurance plans purchased by Lansing area residents and their employers.[44] The acquisition would have given Blue Cross the ability to control physician reimbursement rates in a manner that could harm the quality of health care delivered to consumers. We informed the parties that we would file an antitrust suit to block the transaction, after which the parties abandoned the deal.

The Division also has expeditiously closed matters upon determining that the proposed transaction did not threaten competition. For example, we did not challenge Cisco's acquisition of Tandberg.[45] In that case, we concluded that the proposed deal was unlikely to be anticompetitive due to the evolving nature of the videoconferencing market and the commitments that Cisco had already made to the European Commission to facilitate interoperability. Specifically, because Cisco had committed to facilitate interoperability between its telepresence products and those of other companies, and because of other market factors, such as the evolving nature of the telepresence business, we closed our investigation.

[44] Press release, *Blue Cross Blue Shield of Michigan and Physicians Health Plan of Mid-Michigan Abandon Merger Plans*, (Mar. 8, 2010), available at http://www.justice.gov/atr/public/press_releases/2010/256259.htm.

[45] Press release, *Justice Department will Not Challenge Cisco's Acquisition of Tandberg*, (Mar. 29, 2010), available at http://www.justice.gov/atr/public/press_releases/2010/257173 htm.

CONCLUSION

I hope I have given you a good glimpse of the recent activities at the Antitrust Division, which are all part of our mission to promote competition.

Thank you for your time. I welcome your questions.