Antitrust Handout 5: Mergers
Econ 201/Haworth
Taken from the FTC website
(www.ftc.gov)

Mergers

Many mergers benefit competition and consumers by allowing firms to operate more efficiently. But some mergers change market dynamics in ways that can lead to higher prices, fewer or lower-quality goods or services, or less innovation.

Section 7 of the Clayton Act prohibits mergers and acquisitions when the effect "may be substantially to lessen competition, or to tend to create a monopoly." The key question the agency asks is whether the proposed merger is likely to create or enhance market power or facilitate its exercise. The greatest antitrust concern arises with proposed mergers between direct competitors (horizontal mergers). The FTC and the DOJ have developed Horizontal Merger Guidelines that set out the agencies' analytical framework for answering that key question, and have provided a Commentary on the Horizontal Merger Guidelines that provides many specific examples of how those principles have been applied in actual mergers reviewed by the agencies.

Merger law is generally forward-looking: it bars mergers that may lead to harmful effects. The premerger notification requirements of the Hart-Scott-Rodino Act allow the antitrust agencies to examine the likely effects of proposed mergers before they take place. This advance notice avoids the difficult and potentially ineffective "unscrambling of the eggs" once an anticompetitive merger has been completed. The agencies also investigate some completed mergers that subsequently appear to have harmed customers.

Competitive Effects

The law bars mergers when the effect "may be substantially to lessen competition or to tend to create a monopoly." Three basic kinds of mergers may have this effect: horizontal mergers, which involve two competitors; vertical mergers, which involve firms in a buyer-seller relationship; and potential competition mergers, in which the buyer is likely to enter the market and become a potential competitor of the seller, or vice versa.

Horizontal Mergers

There are two ways that a merger between competitors can lessen competition and harm consumers: (1) by creating or enhancing the ability of the remaining firms to act in a coordinated way on some competitive dimension (coordinated interaction), or (2) by permitting the merged firm to raise prices profitably on its own (unilateral effect). In either case, consumers may face higher prices, lower quality, reduced service, or fewer choices as a result of the merger.

Coordinated Interaction

A horizontal merger eliminates a competitor, and may change the competitive environment so that the remaining firms could or could more easily coordinate on price, output, capacity, or other dimension of competition. As a starting point, the agencies look to market concentration as a measure of the number of competitors and their relative size. Mergers occurring in industries with high shares in at least one market usually require additional analysis.

Market shares may be based on dollar sales, units sold, capacity, or other measures that reflect the competitive impact of each firm in the market. The overall level of concentration in a market is measured by the Herfindahl-Hirschman Index (HHI), which is the sum of the squares of the market shares of all participants. For instance, a market with four equal-sized firms has an HHI of 2500 (252 + 252 + 252 + 252). Markets with many sellers have low HHIs; markets with fewer players or those dominated by few large companies have HHIs approaching 10,000, a level indicating one firm with 100% market share. The larger the market shares of the merging firms, and the higher the market concentration after the merger, the more disposed are the agencies to require additional analysis into the likely effects of the proposed merger.

During a merger investigation, the agency seeks to identify those mergers that are likely either to increase the likelihood of coordination among firms in the relevant market when no coordination existed prior to the merger, or to increase the likelihood that any existing coordinated interaction among the remaining firms would be more successful, complete, or sustainable. Successful coordination typically requires competitors to: (1) reach an agreement that is profitable for each participant; (2) have the means to detect cheating (that is, deviations from the plan); and (3) have the ability to punish cheaters and reinstate the agreement. The coordination may take the form of an explicit agreement, such as agreeing to raise prices or reduce output, or the coordination may be achieved by subtle means — known as tacit coordination. Firms may prefer to cooperate tacitly rather than explicitly because tacit agreements are more difficult to detect, and some explicit agreements may be subject to criminal prosecution. The question is: does the merger create or enhance the ability of remaining firms to coordinate on some element of competition that matters to consumers?

Example: The FTC challenged a merger between the makers of premium rum. The maker of Malibu Rum, accounting for 8 percent of market sales, sought to buy the maker of Captain Morgan's rums, with a 33 percent market share. The leading premium rum supplier controlled 54 percent of sales. Post-merger, two firms would control about 95 percent of sales. The Commission challenged the merger, claiming that the combination would increase the likelihood that the two remaining firms could coordinate to raise prices. Although a small competitor, the buyer had imposed a significant competitive constraint on the two larger firms and would no longer play that role after the merger. To settle claims that the merger was illegal, the buyer agreed to divest its rum business.

Unilateral Effects
A merger may also create the opportunity for a unilateral anticompetitive effect. This type of harm is most obvious in the case of a merger to monopoly — when the merging firms are the only competitors in a market. But a merger may also allow a unilateral price increase in markets where the merging firms sell products that customers believe are particularly close substitutes. After the merger, the merged firm may be able to raise prices profitably without losing many sales. Such a price increase will be profitable for the merged firm if a sufficient portion of customers would switch between its products rather than switch to products of other firms, and other firms cannot reposition their products to entice customers away.

Example: The FTC challenged the merger of two makers of ultrasonic non-destructive testing (NDT) equipment used for quality control and safety purposes in many industries. For many customers, the products of the merging firms were their first and second choice, and evidence showed that the two firms were frequently head-to-head rivals. The merger would have eliminated this beneficial competition on pricing and innovation. To settle the FTC's claim that the proposed merger was illegal, the companies agreed to divest the buyer's NDT business.

Vertical Mergers
Vertical mergers involve firms in a buyer-seller relationship — for example, a manufacturer merging with a supplier of an input product, or a manufacturer merging with a distributor of its finished products. Vertical mergers can generate significant cost savings and improve coordination of manufacturing or distribution. But some vertical mergers present competitive problems. For instance, a vertical merger can make it difficult for competitors to gain access to an important component product or to an important channel of distribution. This problem occurs when the merged firm gains the ability and incentive to limit its rivals' access to key inputs or outlets.

Example: The FTC challenged the combination of an ethanol terminal operator and a gasoline refiner. Refiners need ethanol to create specially blended gasoline, and before the merger, an independent firm with no gasoline sales controlled access to the ethanol supply terminal. After the merger, the acquiring refiner could disadvantage its competitors in the gasoline market by restricting access to the ethanol terminal or raising the price of ethanol sold to them, which would reduce competition for sales of gasoline containing ethanol and raise prices to consumers. As part of a consent agreement, the FTC required the merged firm to create an informational firewall so there could be no preferential access or pricing for its refining affiliate.

Potential Competition Mergers
A potential competition merger involves one competitor buying a company that is planning to enter its market to compete (or vice versa). Such an acquisition could be harmful in two ways.

For one thing, it can prevent the actual increased competition that would result from the firm's entry. For another, it would eliminate the procompetitive effect that an outside firm can have on a market simply by being recognized as a possible entrant. What accounts for that effect? The firms already in the market may avoid raising prices to levels that would make the outside firm's entry more likely. Eliminating the potential entrant through a merger would remove the threat of entry and possibly lead to higher prices.

Example: The FTC has challenged a number of mergers between pharmaceutical companies where one firm is already in the market with an-FDA approved drug and the second company has a drug that is in the approval process and could compete once it is approved. Mergers of this type eliminate a future competitor and further delay price competition for certain drugs.