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Mergers and Acquisitions: Primer on Economic Considerations in the FTC and DOJ Horizontal Merger Approval Process

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Summary

The Federal Trade Commission (FTC) and Department of Justice (DOJ) jointly enforce antitrust laws that cover mergers and acquisitions of large companies. Initially, firms seeking a merger notify the agencies of their intent and provide information on their products and industries. Consumers, competitors, and other interested parties may also notify the enforcement agencies of their concerns. If the enforcement agencies determine a full review is warranted, they acquire more detailed information from the merging firms.

Regulatory agencies focus on several economic criteria to evaluate a proposed merger. First, they define the market according to likely substitution patterns by consumers and calculate the industry concentration. A merger is less likely to be approved if it would result in significant and non-transitory price changes (i.e. market power). Even if the merger would result in market power, the merger may be approved if the market is contestable, that is, if new firms could and likely would enter and compete. Cognizable efficiency, meaning an efficiency that is neither vague nor speculative, is another factor that could allow firms to merge even if market power results. If a firm or division would likely fail anyway, the agencies may permit the merger. In summation, the antitrust enforcement agencies balance likely anticompetitive costs of the proposed merger against likely efficiency gains.

This report will be updated as conditions warrant.

Background

The number and value of mergers in some industries have reached historically high levels. For example, *Businessweek* reports that "merger mania" is sweeping through the pharmaceutical industry.[1] More than 1,000 biotech, medical device, and pharmaceutical companies worth $136 billion were acquired in 2006. The economic effects of mergers and the role that federal agencies play in approving mergers have frequently been the subject of congressional oversight. This report examines the economic factors that are applied in the approval process for horizontal mergers.

The term *horizontal* refers to firms at the same point in the production process. For example, parts of goods are often produced separately and then brought to another firm for assembly. If two firms that purchased parts and then assembled vacuum cleaners wished to merge, they would be considered horizontal firms in the vacuum assembly industry. Extending this example, a vertical merger refers to the merger of a vacuum cleaner assembly firm and a firm that manufactures some of the parts for vacuum cleaners. Approval of proposed horizontal mergers focuses on five economic criteria: (1) market definition, (2) competitive effects, (3) barriers to entry by new firms, (4) cognizable efficiencies[2], and (5) failing firms or divisions.

The Federal Trade Commission (FTC) and the Department of Justice (DOJ) jointly enforce the antitrust laws. The Clayton Act prohibits mergers that may substantially lessen competition or create a monopoly.[3] Section 7a of the Clayton Act, often called the Hart-Scott-Rodino (HSR) Act, requires prior notification of large mergers to both the FTC and DOJ.[4] The regulatory agencies have joint authority over all subject areas but generally divide cases between them according relative expertise in similar cases.

Horizontal Merger Approval Process

In general, the approval process starts with firms providing the two regulatory agencies pre-merger notification and relevant information. The agencies examine the information and if they have concerns issue a second information request. This so-called "second sweep" often requires detailed up-to-date data. Because second sweeps can impose significant costs in both time and money, the regulatory agencies encourage parties to discuss potential issues with agency personnel during the pre-approval process so that second sweeps can be narrowly tailored to the most relevant information.[5]

"Hot documents" are another important element in triggering second sweeps. Hot documents refer to instances in which third parties provide documents that predict merger-related anticompetitive effects.[6] Hot documents often claim that the merger will

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[1] Arlene Weintraub, "More Merger Mania Ahead for Pharma: The Scramble for New drugs is Keeping Companies on the Prowl," *Businessweek*, Jan. 29, 2007, p. 74.

[2] Cognizable in this context means neither vague nor speculative.

[3] See 15 U.S.C. sec 18a.

[4] The American Antitrust Institute provides useful merger information on its website, at [http://www.antitrustinstitute.org/links/merger.cfm].

[5] See the FTC's "Statement of the Federal Trade Commission's Bureau of Competition On Guidelines for Merger Investigations," Dec. 11, 2002.

[6] Federal Trade Commission, *Horizontal Merger Investigation Data, Fiscal Years 1996-2003*,
(continued...)

result in higher prices. However, the regulatory agencies will also consider a document hot if it reasonably claims other anticompetitive effects such as a likelihood that the merger could delay adding new productive capacity or reduce innovation.

Regulatory Agency Economic Analysis

The standards used by the FTC and DOJ to evaluate the economic effects of mergers can be found in "Horizontal Merger Guidelines" issued jointly April 2, 1992. The guidelines state, "the unifying theme of the [horizontal merger] Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise."[7] Market power is defined as the ability of firms to raise prices above the competitive level for a significant time (or lower prices if the merging firms are buyers rather than sellers). Analysis of market power focuses on market definition, competitive effects, entry barriers, cognizable efficiencies, and failing firms.

Market Definition. Defining the relevant market and determining concentration requires an analysis of the products of the merging parties. Although use of general market definitions and concentration levels such as the classifications used by the Bureau of Economic Analysis (BEA) may be acceptable for the initial pre-merger notification, a second sweep often involves more detailed information on the firms' specific products and potential substitutes. Economists in the regulatory agencies use the information to estimate the likelihood and ability of consumers to respond to small increases in the price of the firms' products. The market includes available substitutes even if they are not in the same BEA classification. For example, the substitutes for short distance air-shuttle service may include a bus line rather than a national airline.

The antitrust regulatory agencies consider several factors when calculating market concentration ratios and examining consumer reactions to price changes:[8]

- evidence that buyers have shifted purchases in response to price/quality in the past;
- evidence that sellers conduct their business assuming consumers are flexible;
- evidence of competition in related sectors and industries; and
- evidence of substantial costs to switching products.

Market definition and competition analysis often result in narrower definitions than observers would expect.[9] To determine the scope of the relevant market, analysts use the term *SSNIP*, small but significant and non-transitory increases in price. SSNIP refers to the smallest grouping of products for which a hypothetical monopolist could raise price

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[6] (...continued)
Feb. 2, 2004.

[7] Federal Trade Commission and Department of Justice, *Horizontal Merger Guidelines,* Apr. 2, 1992.

[8] Industry concentration ratios are often referred to as the Herfindahl-Hirschman Index ("HHI").

[9] Shawn Ulrick, "Horizontal Merger Guidelines" before the International Industrial Organization Conference, Apr. 9, 2005.

5%. In the case of ice cream, the SSNIP differentiated super premium ice cream from standard ice cream. Even though there are many regional ice cream brands, the FTC ordered divestiture between Dreyers and Nestle because it determined that the market for “super premium ice cream” was concentrated.

Competitive Effects. In addition to market definition and concentration, the regulatory agencies also consider potential competitive effects of mergers, which can be counter-intuitive. For example, there is some evidence that non-merging firms in an industry may gain more than merging firms do.[10] If market data is available, agency analysts may estimate the own-price elasticity and the cross-price elasticity of demand. Own-price elasticity refers to the percentage change in quantity demanded for a percentage change in the same product’s price. Cross-price elasticity refers to the percentage change in quantity demanded for one product for a percentage change in the price of another product. The merger approval process includes consideration of competitive effects in the industry as a whole, not just the two merging firms.

The ability to raise prices is a common focus of evaluating anticompetitive effects. For example, a wave of mergers in the petroleum industry in the late 1990s raised concerns about competition in that industry. When Exxon Corporation and Mobil Oil proposed a merger in 1999, the FTC evaluated the firms in each product market that they competed. William Baer, director of the FTC’s Bureau of Competition at the time, testified to the House Commerce Committee Subcommittee on Energy and Power that the commission examined the effects of every oil and gas merger for 20 years.[11] The analysis ultimately resulted in permitting Exxon and Mobil to merge.

Barriers to Entry. If a merger is expected to affect market power, then the regulatory agencies determine whether the market is contestable. A contestable market is one without substantial barriers to entry. If the market is contestable, the agencies will consider how likely it is that new suppliers could compete with the merging firms if they tried to exercise market power. If it is unlikely that the merging firms could sustain price increases, then the regulatory agencies may approve the merger even if it temporarily concentrates the industry.[12]

Lack of barriers to entry played an important part in deciding an after-market care automotive merger. In July 1985, the FTC permitted Echlin Inc. to acquire Borg-Warner Corp. because the Commission found that “there are no barriers to entry into the market for the assembly and sale of carburetor kits.”[13] The Commission pointed out that two new firms had entered the business in recent years and that one person had started in the business with a $500 at-home assembly kit.

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[10] Luke Froeb, “Post Merger Product Repositioning,” before the International Industrial Organization Conference, Apr. 9, 2005.

[11] Federal Trade Commission, “Review of Exxon/Mobil Merger to Focus on Competitive Effects and Risks to Consumers: FTC,” press release, Mar 10, 1999.

[12] See *Comment of the Staff of the Bureau of Economics of the Federal Trade Commission*, before the Federal Energy Regulatory Commission, Department of Energy, May 7, 1996.

[13] Federal Trade Commission, *FTC Dismisses Antitrust Charges Stemming from Echlin Acquisition of Borg-Warner Assets,* Docket No. 9157, July 8, 1985.

Cognizable Efficiencies. The regulatory agencies may approve mergers expected to increase market power if the merger would increase economic efficiency. Firms often attempt to improve efficiency by rearranging their *internal* procedures. However, the regulatory agencies recognize that a merger may encourage efficiency by allowing firms to look *externally* for ways to better allocate their productive resources. To facilitate merger approval, any resulting efficiencies must be merger-specific and cognizable.[14] By cognizable the regulatory agencies mean that efficiency claims can not rely on vague or speculative assertions.

Cognizable efficiencies formed the basis for approval of the Genzyme-Novazyme merger.[15] These firms were the only companies trying to develop treatment for a rare disease, Pompe. The merger resulted in the formation of a monopoly. The FTC approved the merger because it was convinced knowledge-sharing between the two scientific research labs provided a better chance of developing a cure for the disease. The Commission weighed the costs of reduced competition against the benefits of shared knowledge.

Failing Firms or Divisions. The regulatory agencies may approve a merger that might otherwise be prevented if one of the firms is failing, or a division of a firm is failing. One argument for allowing this failing-firm defense is that even if the merger is prevented, the market would still become more concentrated if no other firm acquires the firm or division. In asserting the failing-firm defense, parties try to demonstrate that the failing firm (1) would not meet its financial obligations in the near future, (2) is not a viable Chapter 11 candidate, (3) made a good faith effort to secure reasonable offers from other sources, and (4) or division's assets would exit the market if the merger is prevented.

The failing firm defense has critics. On January 24, 2007, Congress heard testimony on the failing firm defense in the context of airline mergers. Consumer advocates argued that the failing firm defense should be limited to an industry "that is otherwise competitive and exhibits a healthy competitive structure."[16] The FTC held hearings on competition policy during the Clinton Administration. An antitrust mergers practitioner argued that merger policy should distinguish between acquisitions intending to infuse capital to compete vigorously in the industry and acquisitions designed to passively maintain a revenue stream.[17]

Table 1 presents data on FTC horizontal merger investigations during 1996-2003. Enforcement action generally declines as the number of significant competitors increases. During the period, the FTC had 573 formal merger investigations (second sweeps). Of those, 441 resulted in enforcement actions and 132 were closed without action.

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[14] Horizontal Merger Guidelines, 1992.

[15] Michael Salinger, "Prepared Remarks Before the Antitrust Modernization Commission" Nov. 17, 2005. Dr. Salinger is the Director, Bureau of Economics, Federal Trade Commission.

[16] Testimony of Mark Cooper, Director Consumer Federation of America, "Impact of Airline Mergers and Industry Consolidation," before Senate Commerce, Science, and Transportation Committee, Jan 24, 2007.

[17] Testimony of Janet McDavid, Hogan and Hartson, LLP, before the FTC, Dec. 5, 1995.

Table 1. FTC Horizontal Merger Investigations 1996-2003

Change in the Number of Competitors	Outcome		Total
	Enforcement Action	Closed with No Action	
2 to 1	128	5	133
3 to 2	156	28	184
4 to 3	102	32	134
5 to 4	32	20	52
6 to 5	13	19	32
7 to 6	2	8	10
8 to 7	6	6	12
9 to 8	0	4	4
10 to 9	2	1	3
10+	0	9	9

Source: Federal Trade Commission

In conclusion, the process of approving corporate mergers has two stages. In the initial stage, merging parties notify the FTC and DOJ of their intentions and attempt to provide enough market information to avoid the costs of a second sweep. If the agencies decide to investigate further, then detailed market information is used to determine likely increases in sustainable market power, if any. In examining sustainable market power, the regulatory agencies focus on market definition, competitive effects, market contestability, cognizable efficiencies, and failing firms. For an example of the merger application process in the utility industry, see CRS Report RL32133, *Federal Merger Review Authorities and Electric Utility Restructuring*, by Aaron M. Flynn, Janice E. Rubin, and Michael V. Seitzinger.