“TALLY-HO!”: UPP AND THE 2010 HORIZONTAL MERGER GUIDELINES

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In his article, The 2010 Horizontal Merger Guidelines: From Hedgehog to Fox in Forty Years,1 Carl Shapiro defends the new Merger Guidelines2 as a transparent “economic toolkit” (“the fox” that “knows many things”) that, over time, has replaced reliance on changes in market concentration (“the hedgehog” that “knows one big thing”) as the Department of Justice’s and Federal Trade Commission’s (Agencies) primary analytical framework under Section 7 of the Clayton Act.3 In Shapiro’s description, the fox has finally triumphed over the hedgehog, enabling the Agencies to use new economic tools (such as Upward Pricing Pressure or UPP) to tackle the complexities of Section 7 analysis for differentiated products.4 While much has been written

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1 Carl Shapiro, The 2010 Horizontal Merger Guidelines: From Hedgehog to Fox in Forty Years, 77 ANTITRUST L.J. 49 (2010) [hereinafter From Hedgehog to Fox].
3 Shapiro, From Hedgehog to Fox, supra note 1, at 50–52.
4 We discuss UPP at length infra in Parts II.B, III, and IV. UPP attempts to measure how the elimination of the competitive constraint operating between two merging parties may affect their potential recapture of sales that may otherwise have been diverted to the merger partner. Several commentators addressing UPP where there is no accompanying offset for efficiencies (or supply responses) refer to it as the “Gross Upward Pricing Pressure Index” or “GUPPI.” Under certain simplifying assumptions, GUPPI measures the value of the recaptured sales using the diversion ratio between the merging firms’ products and the variable price/cost margin earned on the merger partner’s product. See, e.g., Joseph Farrell & Carl Shapiro, Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition, B.E. J. THEORETICAL ECON.: POLICIES & PERSP., vol. 10, no. 1, art. 9, at 23 (2010) [Antitrust Evaluation of Horizontal Mergers], http://www.bepress.com/bejte/vol10/iss1/art9; Steven C. Salop & Serge Moresi, Updating the Merger Guidelines: Comments (Nov. 9, 2009), available at http://www.ftc.gov/os/comments/horizontallmergerreguides/545095-00032.pdf.

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about whether the 2010 Guidelines are in fact “transparent” (for example, UPP is directly referenced only once), Shapiro’s article goes a long way toward explaining the Agencies’ actual analytical process and use of new economic tools that have been developed or refined since the 1992 Merger Guidelines. Most significantly, Shapiro’s article sheds considerable light on UPP and the Agencies’ use of this new tool for merger screening. Shapiro has argued that UPP, as a measure of the value of diverted sales between the merging parties, “is an excellent simple measure for diagnosing or scoring unilateral price effects”—what we regard as an endorsement of relying on UPP to create an express or implied presumption of anticompetitive effects. Thus, in discussing UPP (which we consider one of the most significant changes in the 2010 Guidelines), Shapiro’s article builds on the 2010 Guidelines’ effort to improve transparency at the Agencies.

Transparency, however, is not the primary issue. Now that the Agencies have detailed how they assess whether a proposed horizontal merger may substantially reduce competition in “any line of commerce,” the more fundamental issues are (1) whether the 2010 Guidelines and UPP are consistent with the Clayton Act itself and controlling case law, and (2) whether a UPP screen provides a reliable and proven basis for identifying mergers that may raise significant competitive concern. From these perspectives, Shapiro’s article provides an excellent focal point for joining issue on several substantive legal and economic questions raised by the 2010 Guidelines, including:

(1) whether “market definition” is a statutory predicate for Section 7 analysis;

(2) whether “reasonable interchangeability” remains the controlling, overarching principle for defining markets under Section 7 and, if so, whether the 2010 Guidelines are consistent with reasonable interchangeability standards developed since the Supreme Court’s decision in Brown Shoe Co. v. United States;

(3) whether the 2010 Guidelines’ new hypothetical monopolist test (HMT), which incorporates the use of a UPP screen in that iterative exercise, is consistent with the case law;

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6 Shapiro, From Hedgehog to Fox, supra note 1, at 77; see also Farrell & Shapiro, Antitrust Evaluation of Horizontal Mergers, supra note 4, at 17 (describing UPP as “a simple indicator based on the underlying economics to flag when a horizontal merger seems apt to cause adverse unilateral effects”). As we discuss infra in Part III.B, other jurisdictions have expressly adopted a rebuttable presumption for a UPP indication.


(4) whether UPP is a sufficiently reliable and robust economic tool to support its adoption as a predictive merger screen;

(5) whether the case law and economics support a “unilateral effects” analysis that appears geared toward protecting the product preferences of consumers;

(6) whether the 2010 Guidelines’ treatment of supply responses for assessing unilateral effects—especially in the context of a UPP indication—is consistent with the case law and the economic literature; and

(7) whether, as a matter of law and economics, efficiencies and other potentially procompetitive benefits of a merger should be integral to the Agencies’ unilateral effects analysis.

The answers to these and related questions suggest not only that the Guidelines’ “fox” has not “triumphed,” but that it will be in mortal danger the moment it emerges from its covert and must face judicial scrutiny.9

As an initial matter, market definition unquestionably remains a statutory predicate to finding a Section 7 violation. As early as 1930, the Supreme Court rejected the so-called acquiring-acquired test, which had focused on the competitive effects from eliminating competition between the merging parties.10 The 1950 amendments to Section 7 codified the requirement that a merger’s likely competitive effects be assessed in a broader “line of commerce”11 and twelve years later, in Brown Shoe, the Court held that “‘[d]etermination of the relevant market is a necessary predicate to a finding of a violation of the Clayton Act.’”12 Against this clear statutory language and case law, the revised Merger Guidelines purport to release the Agencies from these requirements—or at least unless and until the Agencies decide to go to court.

The 2010 Guidelines also continue the Agencies’ departure from the “reasonable interchangeability” standard that, in various iterations, has guided courts since Brown Shoe in determining the scope of the relevant market in which to assess competitive effects. For example, the 2010 Guidelines have modified the HMT to define markets through the application of a UPP screen or indication rather than by assessing potential “next best substitutes,” which at least bore some resemblance to a reasonable interchangeability inquiry.

9 Of course, from the legal perspective we do not suggest that this gap in the fauna must be filled by reverting to the “hedgehog” model. Instead, we primarily question the analyses and assumptions inherent in the 2010 Guidelines, including the putative value of UPP, in light of prevailing case law and precedent.


12 370 U.S. at 324 (emphasis added) (quoting United States v. E.I. du Pont de Nemours & Co., 353 U.S. 586, 593 (1957)).
This enables the Agencies to define markets around the parties’ products, even if the majority of diverted sales in the event of a hypothetical price increase would go to products “outside” the “market.”

As for competitive effects, UPP encapsulates the insight that merging parties may consider the value of diverted sales as a factor in their pricing behavior—a general proposition with which we do not disagree. Our focus, instead, is on the issue of whether UPP offers a sufficiently reliable and robust tool to warrant its adoption by the Agencies either as a screen to identify anticompetitive mergers or as “proof” of likely anticompetitive effects in court. In light of UPP’s extremely light judicial record, as well as the absence of demonstrated reliability in predicting real-world competitive effects, we think it is premature, at best, to embrace UPP as a screening tool for merger review.

We are also concerned by the Guidelines’ apparent willingness to embrace a UPP screen—which, by definition, indicates anticompetitive effects—without providing clear and express consideration of how an inevitably positive UPP for merging competitors is to be weighed against dynamic supply responses or demonstrable efficiencies. This concern is amplified by the fact that a positive UPP indication of 5 percent—which Shapiro has suggested as a possible threshold—can readily be satisfied even when the merging firms are not particularly close competitors. Lacking express calibration, the Guidelines simply allow that “[f]urther analysis is required to account for repositioning, entry, and efficiencies.” As a practical matter, this offers little assurance or guidance to practitioners or the business community. Moreover, the seductive simplicity of UPP is likely to make it an overused “tool” in relation to judicially accepted unilateral effects analysis. It also seems unbalanced to apply assumptions built into the UPP screen to support an asserted anticompetitive effect, while at the same time continuing to encumber the analysis of potential supply responses with the more stringent “timely, likely, and sufficient” standard used by the Agencies to assess de novo entry. These same concerns carry over to the consideration of merger efficiencies. As originally conceived, UPP considered efficiencies as an integral part of the equa-

13 See infra Part II.B.2.

14 As we discuss infra in Part II.C.1, the Guidelines’ reference to whether the “value of diverted sales is proportionately small” does not alleviate these concerns. See 2010 Guidelines, supra note 2, § 6.1.

15 Carl Shapiro, Remarks as Prepared for the ABA Section of Antitrust Law Fall Forum 24 (Nov. 18, 2010) [hereinafter Remarks for ABA Section of Antitrust Law Fall Forum], available at http://www.justice.gov/atr/public/speeches/264295.pdf ("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."). The 2010 Guidelines do not provide an express UPP safe harbor, apparently leaving it to the Agencies to decide on a case by case basis whether or how any de facto safe harbor might be applied.

16 See 2010 Guidelines, supra note 2, § 6.1 ex. 19.
tion, recognizing that without an efficiency offset (a “standard deduction”), application of UPP would always indicate a price effect. However, as adopted in the 2010 Guidelines, the UPP screen does not incorporate any express efficiency credit. Eliminating this potential counterweight to the UPP screen—when coupled with the Guidelines’ equally strong skepticism and marginalization of supply-side responses—invisits the serious potential in practice for a “heads I win, tails you lose” application of the 2010 Guidelines.

I. MARKET DEFINITION IS A THRESHOLD STATUTORY REQUIREMENT UNDER SECTION 7

One of the more provocative statements in the 2010 Guidelines is that market definition is no longer an essential step (first or otherwise) in the Agencies’ substantive analysis for assessing mergers involving differentiated products. The notion appears to be that the Agencies can determine whether a merger may substantially lessen competition in a “line of commerce” without focusing on a relevant product market, as the earlier Guidelines required.17 Under the 2010 Guidelines, only when the Agencies decide to go to court (or, presumably, if a structural case may be easy to establish) will they undertake the full “line-drawing exercise” that market definition necessarily entails.18

As we describe below, however, both as a matter of substantive Section 7 law and economics, market definition may not be so easily eschewed. Moreover, one can legitimately question an enforcement policy of using new “tools” that may encourage expansive investigations, potential threats of litigation, and demands for consent decrees—irrespective of whether the Agencies would be able to prove a relevant “line of commerce” in court.19

17 Shapiro, From Hedgehog to Fox, supra note 1, at 55–57. The debate surrounding the necessity of defining relevant product markets is not limited to discussions of the 2010 Guidelines. Professor Louis Kaplow recently published a noteworthy article asserting that the market definition process, and in particular the relevance of market shares to a market power inquiry, is incoherent as a matter of basic economic principles and therefore should be abandoned entirely for the merger review process. See Louis Kaplow, Why (Ever) Define Markets?, 124 HARV. L. REV. 437 (2010).

18 Shapiro, From Hedgehog to Fox, supra note 1, at 58.

19 Some commentators in fact have questioned whether the 2010 Guidelines’ revisions were developed with one eye on some of the Agencies’ major losses in court. See, e.g., Michael N. Sohn, Pricing of Differentiated Products in the 2010 Horizontal Merger Guidelines: Some Unanswered Questions, in 2010 FORDHAM COMPETITION LAW INSTITUTE 135, 136–39 & n.5 (Barry E. Hawk ed., 2011) (describing the origins of the 2010 Guidelines); Hill Wellford & Gregory Wells, The “Litigation Mulligan” in the 2010 Merger Guidelines: Better Economics but Not (Necessarily) More Clarity Before the Agencies and the Courts, CPI ANTITRUST CHRON., Autumn 2010, Vol. 10, No. 2, at 8 (noting that “it is not immediately apparent how codifying the Agencies’ disagreement” with the courts in the recent Section 7 cases the Agencies have lost “would make courts more receptive,” regardless of what “assistance” the 2010 Guidelines claim to be offering).
The 2010 Guidelines certainly discuss market definition and concentration analysis, but the role of those concepts with respect to differentiated products has been significantly diminished. Although the Guidelines recognize that “evaluation of competitive alternatives available to customers is always necessary at some point in the analysis,” they now expressly acknowledge that the Agencies’ analysis often does “not start with market definition.”20 The 2010 Guidelines instead explain that the Agencies need not rely on market definition when another “tool” may be better suited to “more directly predict the competitive effects of a merger.”21

Further, the new Guidelines expressly state that “[e]vidence of competitive effects can inform market definition, just as market definition can be informative regarding competitive effects.”22 The 2010 Guidelines use an example in which evidence that a merger of two firms will result in a significant price increase for at least one of the party’s products, standing alone, can be sufficient to establish a relevant product market; by contrast, the 1992 Guidelines described such evidence as just one factor that “the Agency will take into account.”23 Given these fundamental changes—apparently influenced by UPP, as discussed below—the Section of Antitrust Law of the American Bar Association expressed its concern that “the Agencies might seek to avoid addressing hard questions sometimes presented by the process of defining a relevant market in particular cases.”24 Professor Herbert Hovenkamp also has observed that market definition under the 2010 Guidelines likely will only “play a more

20 2010 Guidelines, supra note 2, § 4.0. We certainly are cognizant of the fact that some merger reviews may conclude without the Agencies defining a relevant market, for example, where the Agencies determine that the absence of barriers to entry or expansion obviates the need to formally define a relevant market. The approach was articulated in the 2006 Commentary on the Horizontal Merger Guidelines: “If the conditions necessary for an anticompetitive effect are not present . . . the Agencies terminate their review because it would be unnecessary to address all of the analytical elements.” U.S. Dep’t of Justice & Fed. Trade Comm’n, Commentary on the Horizontal Merger Guidelines 2 (2006) [hereinafter 2006 Commentary] (emphasis added), available at http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf.

21 2010 Guidelines, supra note 2, § 4.0.

22 Id.

23 Compare id. (“[E]vidence that a reduction in the number of significant rivals offering a group of products causes prices for those products to rise significantly can itself establish that those products form a relevant market.”), with 1992 Guidelines, supra note 5, § 1.11; see also Herbert J. Hovenkamp, Merger Policy and the 2010 Merger Guidelines 43 & n.50 (Univ. of Iowa, Legal Studies Research Paper No. 10-34, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1693246 (follow “One-Click Download” hyperlink).

24 Comments of the ABA Section of Antitrust Law, HMG Revision Project—Comment Project No. P092900, at 7 (June 4, 2010), available at http://www.ftc.gov/os/comments/hmegalleguides/548050-00026.pdf. But see Janet McDavid & Eric Stock, New Horizontal Merger Guidelines Indicate Greater Scrutiny of High Tech and Pharmaceutical Transactions, CPI Anti-
informative and preliminary role than under the 1992 Guidelines, where it often ended the analysis.\footnote{Hovenkamp, supra note 23, at 42–43; see also Wellford & Wells, supra note 19, at 2 (noting that the 2010 Guidelines give the Agencies the opportunity to ignore market definition in difficult cases).}

In both From Hedgehog to Fox and his previous discussions of the 2010 Guidelines and the UPP screen, Shapiro confirms that market definition is now just one item in the Agencies’ toolkit that can be used to examine whether a merger may violate Section 7 of the Clayton Act. As Shapiro explains, economists find it difficult to systematize market definition, particularly where differentiated products are involved.\footnote{Farrell & Shapiro, Antitrust Evaluation of Horizontal Mergers, supra note 4, at 4 n.11 (“While much has been written in antitrust economics on how best to define markets, the fact is that in many differentiated-product industries, there is no clearly right way to draw boundaries that are inevitably somewhat arbitrary.”).} He observes, for example, that in FTC v. Whole Foods Market, Inc.,\footnote{548 F.3d 1028 (D.C. Cir. 2008). The authors’ firm represented Wild Oats in this case.} the market definition inquiry could only “clumsily” approximate “how strongly Whole Foods and Wild Oats were differentiated from traditional supermarkets.”\footnote{Farrell & Shapiro, Antitrust Evaluation of Horizontal Mergers, supra note 4, at 5.} In this sense, the 2010 Guidelines reflect the views of those at the Agencies who have questioned the importance of market definition in merger review and enforcement.\footnote{See, e.g., J. Thomas Rosch, Litigating Merger Challenges: Lessons Learned, Remarks Presented at the Bates White Fifth Annual Antitrust Conference 4 (June 2, 2008), available at http://www.ftc.gov/speeches/rosch/080602litigatingmerger.pdf (“I respectfully suggest that this emphasis on market definition and market shares in merger litigation is wrong as a matter of law and wrong as a matter of economics.”).}

Much like the Guidelines themselves, Shapiro’s article advances an approach that effectively would ease the Agencies’ Section 7 burden regarding market definition at the investigation stage compared to what they may have to prove in court.\footnote{See Farrell & Shapiro, Antitrust Evaluation of Horizontal Mergers, supra note 4, at 4–5.} In fact, it is clear that the new toolkit, including UPP, primarily focuses on predicted merger effects; and then based on these results (and perhaps only if they have to go to court) the Agencies undertake a rigorous analysis to define one or more “relevant markets.”\footnote{Carl Shapiro, Updating the Merger Guidelines: Issues for Upcoming Workshops, Remarks Presented at the Fall Forum for the Antitrust Section of the ABA 5 (Nov. 12, 2009) (“[A]s the importance of market concentration in merger law has declined over the decades, our investigations have focused more on direct evidence of competitive effects, and in some cases we infer the relevant market using the same evidence that leads us to conclude there are likely to be adverse competitive effects.”), available at http://www.justice.gov/atr/public/speeches/251858.pdf. Shapiro appears to have qualified this view somewhat, noting that he has not “suggest[ed] that antitrust enforcement, or the Guidelines, should drop market definition.” Instead, he argues that “market definition and concentration measures can be informative, but are not always, and that UPP can be informative, but is not always.” Joseph Farrell & Carl Shapiro, Upward Pricing}
This approach to merger review appears to be driven by an expectation that, at a minimum, UPP can serve as a reliable initial screening device for predicting competitive effects. In this respect, we do not disagree that an assessment of the value of diverted sales, as captured by the theory behind and calculations of UPP, may offer useful insights in the merger review process. For example, certainly a high UPP indication would suggest performing a thorough assessment of the reasons for margin levels in the industry as well as a careful assessment of relevant demand and supply alternatives. However, as we explain in detail in Parts III and IV below, the combination of UPP’s well-recognized limitations (both theoretical and practical) and the 2010 Guidelines’ conspicuous lack of transparency as to how the Agencies will weigh a positive UPP indication of effects against supply responses (repositioning, expansion, and entry) and efficiencies, makes a UPP screen an unreliable and unproven basis for identifying anticompetitive mergers. For the same reasons, UPP also is an unreliable tool or springboard for conducting intensive merger investigations, demanding consent decrees, or meeting the Agencies’ burden of proof in court. In particular, it is the simplicity of the UPP analysis that may lead the Agencies to unduly rely on UPP in the merger review process. We view this danger as especially present at the investigation stage, where the Agencies have the discretion to impose serious financial costs on parties to proposed transactions without judicial review of the investigatory activities of the Agencies’ enforcement policy. And, of course, the suggestion that market definition is in any sense optional is both misplaced as a matter of Section 7 law and questionable as enforcement policy.\(^{32}\)

**B. MARKET DEFINITION IS A STATUTORY PREDICATE OF SECTION 7**

An informal “survey” of antitrust attorneys—even those focusing on merger work—suggests that few practitioners know about the pre-1950 statutory language and case law history that eventually led to the amendments to Section 7 and, in turn, the Supreme Court’s discussion in *Brown Shoe* regarding the meaning of the “line of commerce” requirement. Given the 2010 Guidelines’ position on market definition—as well as the inevitable battles

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\(^{32}\) See James A. Keyte & Neal R. Stoll, *Markets? We Don’t Need No Stinking Markets! The FTC and Market Definition*, 49 *Antitrust Bull.*, 593, 626 (2004) (“However, notwithstanding the case law and the Merger Guidelines, the agencies have begun to trend away from market definition and structural analysis in merger cases. . . . Some observers have even commented that where there is evidence of actual detrimental effects, market definition is a mere formality, if not completely disregarded.” (footnote omitted)). For a discussion of the policy implications of excluding market definition in the Agencies’ analytical framework, see *infra* Part I.C.
over the market definition requirement that are likely to ensue—a brief review is in order.

As originally fashioned, the Clayton Act targeted stock acquisitions “where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition, or to restrain such commerce in any section or community, or tend to create a monopoly of any line of commerce.” In the decades following the original passage of Section 7, many courts applied this so-called acquiring-acquired test, focusing on the competitive effects from eliminating competition solely between the merging parties rather than in a broader “line of commerce.”

Even by 1930, however, the Supreme Court recognized that by focusing on competition between the merging parties, one could claim that almost any merger harmed competition. Thus, in *International Shoe Co. v. FTC*, the Court held that “[m]ere acquisition by one corporation of the stock of a competitor, even though it result[s] in some lessening of competition, is not forbidden; the [Clayton] act deals only with such acquisitions as probably will result in lessening competition to a substantial degree; that is to say, to such a degree as will injuriously affect the public.”

*International Shoe*, however, did not entirely settle the meaning of Section 7. While most lower courts in the 1930–1950 period interpreted the Court’s language as rendering the acquiring-acquired test a dead letter, arguments that the mere elimination of competition between competitors could violate Section 7 persisted. For example, in the 1930s the Federal Trade Commission continued to argue directly against *International Shoe*, asserting that “where the effect of the acquisition by one corporation engaged in commerce of the stock of another likewise engaged may possibly be ‘to substantially lessen

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34 See, e.g., Swift & Co. v. FTC, 8 F.2d 595, 597 (7th Cir. 1925) (interpreting Section 7 to prohibit “acquisition[s] produc[ing] ‘the effect’ described that the statute condemns,” including “substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition”), rev’d on other grounds sub nom. FTC v. W. Meat Co., 272 U.S. 554 (1926); see also W. Meat Co., 272 U.S. at 557–59 (construing Section 7 to prohibit mergers affecting competition between competitors); Aluminum Co. of Am. v. FTC, 284 F. 401, 405 (3d Cir. 1922) (“Our first inquiry, therefore, is whether in this case the effect was substantially to lessen competition between the two corporations.”).
35 280 U.S. 291, 298 (1930) (emphasis added) (citation omitted).
36 See, e.g., Temple Anthracite Coal Co. v. FTC, 51 F.2d 656 (3d Cir. 1931); see also Milton Handler & Stanley D. Robinson, *A Decade of Administration of the Celler-Kefauver Antimerger Act*, 61 Colum. L. Rev. 629, 657 n.171 (1961) (“On the strength of *International Shoe*, several courts . . . refused to accord a literal reading to the statute and insisted on a showing of a probable substantial lessening of competition in the market as a whole.” (citations omitted)).
competition’ between them, the acquisition is prohibited by the statute.”

In addition, some courts continued to fail to make clear whether they had assessed competition between the merging parties only or in the marketplace as a whole.

Most practitioners today understand the 1950 amendments were motivated by Congress’s desire to close a gap in coverage that prevented the Clayton Act from reaching mergers effectuated through asset acquisitions. They are half right, as closing the asset loophole was the original purpose of the amendments. But the legislative history demonstrates that Congress also was motivated by its desire to make entirely clear that Section 7 was not concerned with the reduction of competition between the merging parties absent marketwide anticompetitive effects. During the Senate debates, for example, the amendments’ primary sponsor, Senator Estes Kefauver, explained that a merger “would not be illegal merely because of the elimination of the competition which had previously existed between the acquiring and acquired firms,” but that it “would have to have the effect of lessening competition generally.” Further, contemporaneous analyses of the legislative history confirm that a significant goal of the amendments was to clarify that a merger cannot be stopped under the Clayton Act merely because of a loss of the previously existing competition between merging competitors. Congress, therefore, amended Section 7 to remove language focusing on competition

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37 Pa. R. Co. v. ICC, 66 F.2d 37, 38 (3d Cir. 1933) (emphasis added), aff’d, 291 U.S. 651 (1934).
38 See, e.g., V. Vivaudou, Inc. v. FTC, 54 F.2d 273, 274 (2d Cir. 1931) (noting that one of the “question[s] presented on this appeal is whether the competition between these companies has been substantially lessened by reason of the stock acquisition”).
40 Throughout this discussion of the legislative history of the 1950 amendments, we recognize, of course, that the Congress that passed the 1950 amendments would also have likely condemned mergers on far lower concentration numbers and market shares than the Agencies and courts apply today. Nevertheless, even against the backdrop of that political climate, the debates over the 1950 amendments demonstrate Congress’s understanding that it was necessary to require marketwide effects of some nature rather than just a diminution of competition between two competitors.
41 96 CONG. REC. 16,456 (1950).
42 See Handler & Robinson, supra note 36, at 652–65 (detailing the legislative history and concluding that removing the acquiring-acquired language from the 1914 statute was an important motivator of the 1950 amendments as passed); see also Note, The ABC’s of Clayton 7: Amendment of 1950; Brown Shoe; The Court and Current Complexities, 10 V ILL. L. REV. 734, 755 (1965) (describing elimination of the acquiring-acquired test as the 1950 amendments’ “second major change” to Section 7); Note, Section 7 of the Clayton Act: A Legislative History, 52 COLUM. L. REV. 766, 770 (1952) (describing the elimination of the acquiring-acquired test, along with closing the asset loophole, as the two primary purposes of the amendments).
between the merging parties, instead making the sole inquiry of concern the effects in a “line of commerce”:

[N]o corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.\(^{43}\)

Twelve years later, in *Brown Shoe*, the Supreme Court first assessed whether the amended Section 7 language imposed a product market definition requirement in all Section 7 cases. The Court considered the amended statutory language in the context of a merger between Brown Shoe—the third largest seller of shoes in the United States—and Kinney, the eighth largest seller.\(^{44}\) Noting the “extensive legislative attention to the measure, and the broad, general language finally selected by Congress for the expression of its will,”\(^{45}\) the Court (like the academic commentators before it) found that “[t]aken as a whole, the legislative history illuminates congressional concern with the protection of competition, not competitors, and its desire to restrain mergers only to the extent that such combinations may tend to lessen competition.”\(^{46}\) Accordingly, the Court concluded:

As we have previously noted, “[d]etermination of the relevant market is a necessary predicate to a finding of a violation of the Clayton Act because the threatened monopoly must be one which will substantially lessen competition ‘within the area of effective competition.’ Substantiality can be determined only in terms of the market affected.” The “area of effective competition” must be determined by reference to a product market (the “line of commerce”) and a geographic market (the “section of the country”).\(^{47}\)

Since *Brown Shoe*, courts have consistently interpreted Section 7’s “line of commerce” language to require definition of the relevant market.\(^{48}\)

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\(^{45}\) Id. at 312.

\(^{46}\) Id. at 320.

\(^{47}\) Id. at 324 (second alteration in original) (emphasis added) (footnote omitted).

This decisive holding is no less applicable today. In *Whole Foods*, the D.C. Circuit rejected any attempt to sidestep the market definition requirement:

The FTC suggests that “market definition . . . is a means to an end—to enable some measurement of market power—not an end in itself.” But measuring market power is not the only purpose of market definition; only “examination of the particular market—its structure, history, and probable future—can provide the appropriate setting for judging the probable anticompetitive effect of the merger.” *Brown Shoe*, 370 U.S. at 322 n.38.49

Substantive Section 7 law on demonstrating anticompetitive effects in a line of commerce has undoubtedly changed since the 1950 amendments and *Brown Shoe*. Moreover, Congress and the courts in the years following the 1950 amendments took what is now considered a very restrictive view of how mergers between competitors may tend substantially to lessen competition. What cannot be denied, however, is that as of 1950—and certainly today—the marketwide harm required by the statute contemplates more than the mere elimination of competition between the merging parties. And, yet, the essence of the 2010 Guidelines’ adoption of UPP—without any express calibration, “safe harbor,” or guidance about presumptions that the Agencies may attach to UPP—implies a Section 7 harm merely when two competitors merge.

Thus, not only is the marginalization of market definition in the new Merger Guidelines directly contrary to this statutory requirement, it appears to have been replaced by a UPP screen that in a large sense operates as a modern mathematical representation of the “acquiring-acquired” effects test that Congress expressly rejected in 1950. Indeed, to the extent a UPP screen is either adopted or used in practice as a presumption or proof of anticompetitive effects, the Agencies are inviting history to repeat itself with a decision along the lines of *International Shoe*, which long ago confirmed that the mere re-

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duction of competition between two merging parties cannot by itself violate Section 7.

C. A “Heads I Win, Tails You Lose” Approach to Market Definition Offers No Guidance

An equally troubling inference to be drawn from the Agencies’ diminished focus on market definition is that they may be inclined to use market definition against merging parties when it favors the Agencies, but may rely on a UPP screen (or other tools)—especially before going to court—when it does not. While somewhat cynical, this view is invited by the Guidelines’ discussion of market definition. The underlying assumption is that the Agencies have the discretion to undertake extended investigations (with their attendant costs on the merging parties) or pursue possibly questionable remedies and consent decrees solely based on arithmetic UPP indications of competitive effects, and without having to comply with Section 7’s “predicate” market definition requirement.

Such an approach would not be sound enforcement policy and certainly cannot reassure the business community that the Guidelines have predictive value for making informed risk assessments. Moreover, only when the Agencies construct guidelines (and enforcement decisions) around what the statute actually requires can the deterrent effect of enforcement activity be aligned with the congressional intent behind Section 7. Under the 2010 Guidelines, however, we are likely to see yet more Section 7 investigations (and perhaps even filed actions) based on the Agencies’ new screening tools, such as UPP, with market definitions that are questionable under judicial precedent. Finally, to the extent that the Agencies—and especially the FTC under Section 13(b)50—may be able to block a merger at the preliminary injunction stage without establishing a relevant market (which, if granted, often leads the parties to abandon the deal), the intent of Section 7 to protect overall competition in a relevant line of commerce is even less well served.

50 See FTC v. CCC Holdings Inc., 605 F. Supp. 2d 26 (D.D.C. 2009). The court in CCC Holdings held that Section 13(b)’s reference to a “likelihood of ultimate success” does not require the FTC to show that it is likely to succeed at trial. Rather, the “burden of showing likelihood of success on the merits is met if the Commission has ‘raised questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals.’” Id. at 36 (citation omitted). The court did, however, recognize a sliding scale that takes into account equitable factors in a party’s favor balanced against the Commission’s likelihood of ultimate success. Id. at 35. Of course, where the FTC cannot meet even this arguably lower standard on the subject of market definition, Section 13(b) will be of no help to the Commission. See FTC v. Lab. Corp. of Am., No. SACV 10-1873 AG (MLGx), 2011 U.S. Dist. LEXIS 20354, at *1, *47 (C.D. Cal. Feb. 22, 2011) (denying preliminary injunction where the FTC’s proposed product market ignored the “‘rule of reasonable interchangeability’” (citation omitted)).
II. THE AGENCIES CONTINUE TO DISTANCE THE GUIDELINES FROM THE ESTABLISHED REASONABLE INTERCHANGEABILITY STANDARD FOR MARKET DEFINITION

As described in greater detail below, a major, though seldom discussed, change in the 2010 Guidelines is the modification of the HMT to define markets around a UPP indication—i.e., permitting a market to be defined even as narrowly as the merging parties’ products if, for example, a hypothetical monopolist of those products could appear to exert an upward pressure on the price of just one of those products.51 Not only is this a significant departure from the standard HMT exercise of adding the “next best substitutes” where a “small but significant non-transitory increase in price” (SSNIP) would not be profitable, it removes the Agencies’ analytical framework even further from the reasonable interchangeability standard that remains the bedrock judicial principle for defining markets under Section 7.

A. THE 2010 GUIDELINES PAY LITTLE ATTENTION TO REASONABLE INTERCHANGEABILITY, CONTRARY TO JUDICIAL PRECEDENT AND SOUND ECONOMICS

Ironically, unlike the 1992 Guidelines, the 2010 Guidelines explicitly mention reasonable interchangeability, though only in the context of the HMT.52 As the revised Guidelines state, “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,” and they “employ the hypothetical monopolist test to evaluate whether groups of products in candidate markets are sufficiently broad to constitute relevant antitrust markets.”53 Critically, however, the revised Guidelines now explain that “[t]he hypothetical monopolist test may identify a group of products as a relevant market even if customers would substitute significantly to products outside that group in response to a price increase.”54 This somewhat remarkable statement is made possible by the insertion of UPP into the HMT iterative exercise, which allows a “market” to be declared any time a candidate of products may result in a UPP indication on one or more of those products, irrespective of the amount of hypothetical substitution that would flow to other substitutes.55

In order to fully appreciate the disconnect between the UPP version of the HMT—which we address in detail below56—and the courts’ understanding

51 See discussion infra Part II.B.3.
52 2010 Guidelines, supra note 2, § 4.1.1.
53 Id.
54 Id. (emphasis added).
55 Id.
56 See discussion infra Parts II.B.2–II.B.3.
and application of the reasonable interchangeability standard for defining relevant markets under Section 7, it is useful to examine the state of law on this fundamental principle, including the relevance of cross-elasticity, consumer preferences, and so-called core or inframarginal consumers.

1. Courts Continue to Embrace the Reasonable Interchangeability Standard

In the Supreme Court’s first attempt to address the meaning of a “line of commerce” under the Clayton Act, Brown Shoe articulated what has now become the established rule for defining a relevant product market: “The outer boundaries of a product market are determined by the reasonable interchangeability of use [by consumers] or the cross-elasticity of demand between the product itself and substitutes for it.”57 The Court explained that, within such a market, there may be “submarkets,” defined by such “practical indicia” as “industry or public recognition of the submarket as a separate economic entity, the product’s peculiar characteristics and uses, unique production facilities, distinct consumers, distinct prices, sensitivity to price changes, and specialized vendors.”58 Nevertheless, Brown Shoe emphasized that “the boundaries of the relevant market must be drawn with sufficient breadth to include the competing products of each of the merging companies and to recognize competition where, in fact, competition exists.”59

From a historical perspective, during the 1960s courts went down the path of defining narrower and narrower markets without reference to economic principles, which sometimes resulted in defining markets based on a single product. For example, in United States v. Aluminum Co. of America, the Supreme Court recognized the “competition between insulated aluminum conductor and its copper counterpart,” but still held that the “degree of competitiveness does not preclude their division for purposes of § 7 into sepa-


58 Brown Shoe, 370 U.S. at 325.

59 Id. at 326.
rate submarkets.”\textsuperscript{60} Justice Potter Stewart’s dissent rightly criticized the majority, explaining that “there is complete manufacturing interchangeability between copper and aluminum,” and “supply flexibility . . . exerts a profound restraint upon an aluminum cable manufacturer’s power to achieve any sort of market advantage.”\textsuperscript{61} Moreover, since that time, economic rigor eventually overtook simplistic “submarket” analyses to the point that, in the past two decades, the submarket concept has all but exited the antitrust lexicon.\textsuperscript{62} Thus, while courts or commentators may still discuss the \textit{Brown Shoe} factors, they usually do so in the context of determining whether the \textit{Brown Shoe} “indicia” reveal certain identifiable customers that, because of their particular requirements or objective preferences, may be subject to hypothetical price increases notwithstanding the availability of potential functional substitutes.\textsuperscript{63}

Courts now routinely find that reasonable interchangeability does not require products or services to be “perfect substitutes,” but instead turns on the consumers’ alternatives for the use or function in question. As the Court in \textit{United States v. Continental Can Co}, first explained:

Metal has replaced glass and glass has replaced metal as the leading container for some important uses; both are used for other purposes; each is trying to expand its share of the market at the expense of the other; and each is attempting to preempt for itself every use for which its product is physically suitable.\textsuperscript{64}

These functional considerations led the Court to conclude that the products competed in the same market, even “though the interchangeability of use may not be so complete and the cross-elasticity of demand not so immediate as in the case of most intra-industry mergers.”\textsuperscript{65}

For nearly fifty years, courts have taken this message to heart, routinely defining markets based on “reasonable interchangeability” of function, and focusing in particular on the ability of customers to turn to other functionally equivalent products as substitutes.\textsuperscript{66} For example, the court in \textit{United States v. Continental Can Co}. noted:  

\begin{quotation}
Metal has replaced glass and glass has replaced metal as the leading container for some important uses; both are used for other purposes; each is trying to expand its share of the market at the expense of the other; and each is attempting to preempt for itself every use for which its product is physically suitable.\textsuperscript{64}
\end{quotation}

\textsuperscript{60} 377 U.S. 271, 275 (1964).
\textsuperscript{61} Id. at 285 (Stewart, J., dissenting).
\textsuperscript{62} See 1 ABA \textit{SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS}, ch. 3B (6th ed. 2007) [hereinafter \textit{ANTITRUST LAW DEVELOPMENTS}].
\textsuperscript{63} For a discussion of this potential “price-discrimination” inquiry from a market definition perspective, see discussion \textit{infra} Part II.A.4.
\textsuperscript{64} 378 U.S. 441, 453 (1964) (footnote omitted). The Court also considered the behavior of suppliers, observing that “[i]n differing degrees for different end uses manufacturers in each industry take into consideration the price of the containers of the opposing industry in formulating their own pricing policy,” \textit{Id.} at 453–55.
\textsuperscript{65} \textit{Id.} at 454.
\textsuperscript{66} While courts emphasize the demand side, supply substitutability can also affect reasonable interchangeability. \textit{See Brown Shoe Co. v. United States}, 370 U.S. 294, 367 (1962) (Harlan, J., concurring in part, dissenting in part) (“Such an analysis, taking into account the interchangeability of production, would seem a more realistic gauge of the possible anticompetitive effects in
SunGard Data Systems relied on this line of cases, holding that “’[i]nterchangeability of use and cross-elasticity of demand look to . . . the availability of products that are similar in character or use to the product in question and . . . the degree to which buyers are willing to substitute those similar products for the product.’”67 As the court explained, while such an analysis may well depend on some mix of economic and price data and other “practical indicia,” the outcome must reflect competitive reality.68 The key insight from these cases, which holds true today, is that competitive products should nearly always belong in the same relevant product market so long as the products are functionally and reasonably interchangeable from the customers’ perspective. This fact-driven inquiry requires the Agencies and the courts to assess the full range of demand-side and supply-side substitutes that form the totality of constraints on the merging parties’ potential incremental market power.69

Indeed, even in the wake of the 2010 Merger Guidelines, courts continue to find that the “‘proper point of departure in any discussion of the relevant product market’ is the ‘rule of reasonable interchangeability.’”70 In FTC v. Laboratory Corp. of America, for example, the Commission sought a preliminary injunction based in part on a product market definition limited to “‘the sale of capitated clinical laboratory testing services . . . to physician

the shoe manufacturing industry of a merger between a shoe manufacturer and a retailer than the District Court’s compartmentalization in terms of the buying public.”; see also Kaiser Alumi-
num & Chem. Corp. v. FTC, 652 F.2d 1324, 1330 (7th Cir. 1981) (“Cross-elasticity of supply, or production flexibility among sellers, is another relevant factor . . . in defining a product market . . . .”); Equifax, Inc. v. FTC, 618 F.2d 63, 66 (9th Cir. 1980) (“It is well settled that cross-elasticity of supply is a valid basis for determining that two commodities should be within the same market.”); New York v. Kraft Gen. Foods, Inc., 926 F. Supp. 321, 361 (S.D.N.Y. 1995) (defining the product market as “all ready-to-eat cereals” was “reinforced by the court’s consideration of supply substitutability in the [ready-to-eat] cereal industry”); United States v. Syufy Enters., 712 F. Supp. 1386, 1398 (N.D. Cal. 1989) (noting that both cross-elasticity of demand and cross-elasticity of supply are relevant to market definition, though most cases focus on cross-elasticity of demand), aff’d, 903 F.2d 659 (9th Cir. 1990).


68 SunGard Data Sys., 172 F. Supp. 2d at 182.

69 This is not just a legal principle, but rather sound economics as well. See discussion infra Part II.A.5.

groups." The court ruled against the Commission—i.e., found a lack of likely success on the merits—because the FTC’s market definition did not account for readily available alternative methods of payment (i.e., non-capi-
tated) for the relevant services, notwithstanding differences in price or method of payment.

The FTC may also find it difficult to distance itself from the established principle of reasonable interchangeability given its position on appeal in FTC v. Lundbeck, Inc. There, the lower court had found that two drugs were not in the same product market because of perceived product differences (e.g., side effects) and an apparent lack of cross-elasticity of demand. On appeal, the FTC vigorously argued that products should be in the same market if they are reasonably interchangeable in terms of “the alternatives to which consumers could practicably turn”—i.e., products that are capable of taking business away from each other. In fact, the FTC relied on United States v. Oracle Corp. for the proposition that customer testimony concerning preferences for particular products cannot trump evidence of the practical choices available to consumers for the same function.

In sum, “reasonable interchangeability” remains the guiding judicial principle for defining product markets, irrespective of the degree to which the principle is reflected in the 2010 Guidelines.

2. Cross-Elasticity Can Be Informative, But It Is Not Required

Within the overarching principle of reasonable interchangeability for defining markets lies an acknowledged, useful economic tool: cross-elasticity of demand. The concept of cross-elasticity approximates the responsiveness of the demand for one product to a change in price of another. If the two goods are substitutes, then the cross-elasticity of demand will be positive—in other words, as the price of one product rises, the demand for the other also will rise (all else remaining constant). In the case of perfect substitutes (for instance, commodity products), cross-elasticity is equal to positive infinity. For imperfect substitutes (like differentiated products), cross-elasticity will remain positive but may fall within a range of values that reflect the relative “closeness” of competition between the products.

Where data are available (which often is not the case), courts continue to consider cross-elasticity when delineating an appropriate “line of commerce,”

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71 Id. at *8 (alteration in original) (citation omitted).
72 See Brief for Plaintiffs-Appellants FTC and State of Minnesota, FTC v. Lundbeck, Inc., Nos. 10-3458, 10-3459 (8th Cir. filed Dec. 27, 2010).
73 Id. at 29.
74 Id. at 33 n.4 (citing United States v. Oracle Corp., 331 F. Supp. 2d 1098, 1131 (N.D. Cal. 2004)).
and Brown Shoe clearly indicates that the concept of “cross-elasticity” is relevant to the market definition inquiry. Yet, the term has remained rather enigmatic in the case law describing relevant markets. No court has definitively set out a framework for defining what constitutes “high” or “low” cross-elasticity in a borderline case. Moreover, even if such a line could be drawn, parties often have incomplete or inconclusive data from which to estimate cross-elasticities, which in turn often leads to more qualitative indications of cross-elasticity. Thus, courts generally find products with “high” cross-elasticity to be in the same market, even if that conclusion is based only on qualitative indicators.

For example, in SunGard, the court determined that both internal hot sites and shared hot sites operated in the same relevant market based on high cross-elasticities. It extrapolated that cross-elasticities were high from information that customers would likely switch to internal hot sites in response to a price increase for shared hot sites. Similarly, in New York v. Kraft General Foods, Inc., the court found that all ready-to-eat cereals were in the same market because of high cross-elasticities of demand, ignoring some of the more superficial differences between various types of cereal. Courts have also used evidence of “low” cross-elasticity to find products are in separate markets.

Importantly, however, cross-elasticity often does not tell the whole story of a “market”—it focuses on competition between two particular goods at a particular point in time to indicate whether they are in the same market. As one commentator observed, “Cross-elasticity is relevant only because it is closely related to own-elasticity . . . [which] is determined largely by the cross-elasticities of demand for that product with other products.”

75 See, e.g., United States v. Archer-Daniels-Midland Co., 866 F.2d 242, 248 (8th Cir. 1988) (discussing “high” cross-elasticity but not defining the term) (“To be relevant, the cross-elasticity of demand must be sufficiently high to statistically reflect consumers’ perception that the two products are reasonably interchangeable.” (citing United States v. Empire Gas Corp., 537 F.2d 296, 303 (8th Cir. 1976))); id. (“The greater the positive cross-elasticity of demand between two products is, the closer substitutes they are.” (quoting Smith Kline Corp. v. Eli Lilly & Co., 575 F.2d 1056, 1063 (3d Cir. 1978))); id. (citing Rothery Storage & Van Co. v. Atlas Van Lines, Inc., 792 F.2d 210, 218 (D.C. Cir. 1986) (the higher the cross-elasticity of demand is, the more likely the two products are in the same relevant product market)).

76 See Antitrust Law Developments, supra note 62, ch. 6B.


78 Id. at 188.


80 See Archer-Daniels-Midland Co., 866 F.2d at 246 (low cross-elasticity between high fructose corn syrup and sugar); Beatrice Foods Co. v. FTC, 540 F.2d 303 (7th Cir. 1976) (low cross-elasticity between paint rollers and paint brushes).

81 Gregory J. Werden, Market Delineation and the Justice Department’s Merger Guidelines, 1983 Duke L.J. 514, 573; see also ABA Section of Antitrust Law, Mergers and Acquisitions: Understanding the Antitrust Issues 47 (3d ed. 2008) [hereinafter Mergers and Acquisitions] (discussing the intersection of cross-elasticity and own-elasticity) (“As one might
cross-elasticities [may] provide a poor indication of the extent to which a monopolist would increase price[s] [because] [a] monopolist contemplating a price increase cares about the proportionate amount by which the quantity demanded of its own product falls as price rises, which is indicated by the own-elasticity of demand.” 82 Accordingly, “while cross elasticities provide useful information, economists generally believe that they do not provide a sufficient basis for defining relevant markets.” 83

Finally, even where cross-elasticity may have a role, reasonable interchangeability remains the judicial touchstone of relevant market definition. 84 As summarized by the ABA Section of Antitrust Law, “Because of these interpretation problems and the problems of proof associated with the measurement of cross-elasticities, both the courts and the federal agencies use cross-elasticity not as the dispositive factor, but only as one important factor to be considered.” 85 This is also the position that the FTC took in the Lundbeck appeal, in which the Commission emphasized both the overriding importance of reasonable interchangeability and the drawback of attempts to measure or deduce cross-elasticities over short time horizons. 86

expect, the own price elasticity for a given product will depend on its cross-elasticities with other products, but high cross elasticities are not the only determinant. It can be shown that the impact of any particular substitute will also depend on the ratio of consumers’ expenditures on the two products.” 87

82 Werden, supra note 81, at 573 (emphasis added); see also id. at 573–74 (discussing reasons why cross-elasticity fails to capture what firms actually do when considering a price increase and noting that the “magnitudes of the cross-elasticities between a product and each of its substitutes may not be nearly as important as the number of substitutes a product has”). For an example of a court endorsing this concept, see United States v. Engelhard Corp., 970 F. Supp. 1463, 1472 (M.D. Ga.) (“[B]y ignoring evidence of substitution in response to small price changes . . . the relevant question—is there cross-elasticity of demand between [gelant quality attapulgite clay] and other products—once again appears approached but unanswered [by the FTC’s evidence].” (emphasis added)), aff’d, 126 F.3d 1302 (11th Cir. 1997).

83 MERGERS AND ACQUISITIONS, supra note 81, at 48. In Lundbeck, for example, the parties’ economic experts agreed that a showing of cross-elasticity was unnecessary to define a relevant market. See FTC v. Lundbeck, Inc., Nos. 08-6379, 08-6381 (JNE/JJG), 2010 WL 3810015, at *20–21 (D. Minn. Aug. 31, 2010).

84 Kaiser Aluminum & Chem. Corp. v. FTC, 652 F.2d 1324, 1330 (7th Cir. 1981) (“[T]he clearest indication that products should be included in the same market is if they are actually used by consumers in a readily interchangeable manner.”); United States v. Ford Motor Co., 286 F. Supp. 407, 411 (E.D. Mich. 1968) (describing reasonable interchangeability as the “fundamental quality of any properly delineated market”).

85 MERGERS AND ACQUISITIONS, supra note 81, at 54 (footnote omitted); see also United States v. Mrs. Smith’s Pie Co., 440 F. Supp. 220, 227–28 (E.D. Pa. 1976) (considering expert testimony that purportedly demonstrated “a relatively low price elasticity,” but finding this evidence to be “completely useless” because courts have “no basis for evaluating what a particular elasticity coefficient means”).

86 See Brief for Plaintiffs-Appellants, supra note 72, at 29. The FTC relied on H.J. Inc. v. International Telephone & Telegraph Corp., 867 F.2d 1531 (8th Cir. 1989), which in the Section 2 context held that functional substitutes must be included in the relevant market even if they are significantly differentiated, id. at 1538 (“Products always face at least the possibility of competition from the products they are meant to supercede. It makes no sense to say that an entrant with
From a broader perspective, the case law demonstrates that courts have been reluctant to place too much value on simplified calculations that attempt to define the relevant line of commerce—caution we expect eventually will also apply to UPP as a HMT component or a screen for proof of effects. Thus, although cross-elasticity calculations can be instructive when available, courts generally have been unwilling to base their market definition determinations on calculations that often build on various assumptions and questionable proof.87

3. Relevant Product Markets Cannot Be Defined Based Solely on Consumer Preferences

While the case law remains somewhat murky on the role of cross-elasticity, it is now well-established precedent that consumer preferences are, at most, a component of reasonable interchangeability and should not provide a separate basis for defining a relevant market.88 Courts have observed that the alternative conclusion would be illogical because, taken to its extreme, it would allow a single purchaser with sufficiently rigid, subjective preferences to define any product market.89

Oracle addressed this issue head-on, finding that evidence of consumer preferences is simply one aspect of reasonable interchangeability. Specifically, Oracle addressed the reality that narrowly drawn product markets often fail to capture the manner in which consumers actually purchase products. The court observed that “[c]ustomer preferences towards one product over another do not negate interchangeability.”90 Thus, in discussing consumers of the software solutions from Oracle and PeopleSoft, the court explained that

a new technology has monopoly power by defining the market as those customers whom the entrant has so far managed to persuade. All new entrants, indeed most competitors, would then be monopolists.” (citation omitted)).


As we explain infra in Part II.A.4, courts have found that consumer preferences may support narrower markets where a group of consumers are incapable of switching and thus are vulnerable to price discrimination. Cf. FTC v. Whole Foods Mkt., Inc., 548 F.3d 1028, 1038 (D.C. Cir. 2008) (Brown, J.) (“[I]n some situations core customers, demanding exclusively a particular product or package of products, distinguish a submarket.”). See, e.g., Lockheed Martin Corp. v. Boeing Co., 314 F. Supp. 2d 1198, 1228–29 (M.D. Fla. 2004).

United States v. Oracle Corp., 331 F. Supp. 2d 1098, 1131 (N.D. Cal. 2004) (citing R.R. Donnelley & Sons Co., 120 F.T.C. 36, 54 n.65 (1995)); see also Robert Pitofsky, New Definitions of Relevant Market and the Assault on Antitrust, 90 COLUM. L. REV. 1805, 1816 (1990) (“There will almost always be classes of customers with strong preferences . . . but to reason from the existence of such classes to a conclusion that each is entitled to . . . a separate narrow market definition grossly overstates the market power of the sellers.”).
the issue “is not what solutions the customers would like or prefer for their data processing needs; the issue is what they could do in the event of an anticompetitive price increase by a post-merger Oracle.” 91 And, most recently, the FTC in its appeal of Lundbeck adopted this position, asserting that “the court was required to ‘inquir[e] into the choices available to consumers.’” For such an inquiry, this Court has consistently focused on the alternatives to which consumers could practically turn, and it has rejected analyses focused solely on current customer perceptions and habits.” 92

Whole Foods applied similar principles of reasonable interchangeability as Oracle—though one may critique the application of those principles to the facts, including consumer preferences. Commentators have questioned whether the court identified a distinct group of so-called core consumers—for whom only a “particular package of goods and services” is suitable, as opposed to marginal consumers—who are simply more sensitive to price. 93 The court took these varying price sensitivities to “indicate[ ] the existence of a submarket of core customers, operating in parallel with the broader market but featuring a different demand curve.” 94

In any event, courts continue to reject arguments that they should define a relevant product market based solely on consumers’ preferences—including in the context of an attempt to use UPP to do so. For example, in City of New York v. Group Health Inc., New York City challenged the merger of two health plan providers, Group Health, Inc. (GHI) and HIP Foundation, Inc. (HIP), both of which were members of the City’s health benefits program. 95 Notably, both GHI and HIP were the two lowest cost providers in the City’s health benefits offering. The City argued that the relevant market should be limited to the “low-cost municipal health benefits market,” a relevant market which, as a result of the City’s gatekeeping role in selecting health plan providers, was limited to GHI and HIP. 96

Judge Richard Sullivan rejected the City’s proposed relevant market since the product market at issue—the various insurance plans municipal workers

91 Oracle, 331 F. Supp. 2d at 1131.
92 Brief for Plaintiffs-Appellants, supra note 72, at 29 (alteration in original) (emphasis added) (citation omitted).
94 Whole Foods, 548 F.3d at 1038–39.
95 No. 06 Civ. 13122 (RJS), 2010 WL 2132246 (S.D.N.Y. May 11, 2010).
96 Id. at *3–4 (internal quotation marks omitted) (citation omitted).
may choose from—is determined mainly by the City’s preferences. In granting the defendants’ summary judgment motion, Judge Sullivan wrote:

[T]he record is clear that the major distinguishing feature of the plans in the City’s purported market is that, unlike other plans, the plans in the market have been approved by the City for inclusion in the Health Benefits Program after a lengthy bidding process. Yet the law is equally clear that the preferences of a single purchaser cannot define a product market, and that “[p]urchasing constraints on a single consumer, such as a required competitive bidding procedure, do not” create a market of which only that consumer is a member.97

While the court in Group Health acknowledged that consumers had preferences for various features, it held that the City’s claims that such preferences amounted to a relevant market were untenable. The court cited to a prior decision in which then-Judge Sonia Sotomayor had explained that defining markets around particular consumer preferences “is analogous to a contention that a consumer is ‘locked into’ Pepsi because she prefers the taste, or NBC because she prefers ‘Friends,’ ‘Seinfeld,’ and ‘E.R.’”98 The court concluded that “‘[a] consumer might choose to purchase a certain product because the manufacturer has spent time and energy differentiating his or her creation from the panoply of products in the market, but at base, Pepsi is one of many sodas, and NBC is just another television network.’”99 Group Health is thus another example of a case rejecting the protection of non-price preferences as a proper goal of the market definition inquiry.100

Where, however, consumer preference reflects actual product differences based on function, quality, or other competitive variables, courts have been more willing to consider “preference” as part of their market definition analysis. These considerations, in effect, are trying to capture the extent of interchangeability, rather than simple preference.

97 Id. at *4 (second alteration in original) (citations omitted).
98 Global Disc. Travel Servs., LLC v. TWA, Inc., 960 F. Supp. 701, 705 (S.D.N.Y. 1997). As Judge Sotomayor explained in the context of discount airline tickets, “[a] consumer might prefer flying TWA because a flight from City X to City Y leaves at a better time in the afternoon, or has better other terms, than the same flight from City X to City Y on Continental,” but “[f]light times, dates, mileage, and other factors are simply features that enhance the enjoyment of the product.” Id.
99 Group Health, 2010 WL 2132246, at *3 (alteration in original) (quoting Global Discount Travel Services, 960 F. Supp. at 705). The court also expressly rejected the UPP analysis (“The Court notes that its research has not revealed a single decision of a federal court adopting the UPP test. In light of the case law’s clear requirement that a Plaintiff allege a particular product market in which competition will be impaired, this absence of authority is hardly surprising.”). Id. at *6 n.6.
For example, in *United States v. Visa U.S.A., Inc.*, the court accepted the plaintiffs’ expert’s assertion that “[i]n many circumstances, consumers strongly prefer to use credit and charge cards rather than cash or checks, because they generally do not want to carry large sums of cash to make large purchases, and checks generally have much lower merchant acceptance than either cash or general purpose cards.” The court also noted that “although it is literally true that, in a general sense, cash and checks compete with general purpose cards as an option for payment by consumers and that growth in payments via cards takes share from cash and checks in some instances, cash and checks do not drive many of the means of competition in the general purpose card market.” The court accepted the plaintiffs’ analogy to airplane travel, noting “that while it is true that at the margin there is some competition for customers among planes, trains, cars and buses, the reality is that airplane travel is a distinct product in which airlines are the principal drivers of competition.” Accordingly, the court ruled that “because card consumers have very little sensitivity to price increases in the card market and because neither consumers nor the defendants view debit, cash and checks as reasonably interchangeable with credit cards, general purpose cards constitute a product market.”

The court in *Visa* thus used consumer preference as a proxy for determining the extent of functional reasonable interchangeability in defining the relevant market. To assert a market simply based on a consumer’s subjective preferences, however, provides no meaningful guidance for a court to evaluate the likely competitive effects of a proposed merger.105

4. **Narrow Product Markets Based on “Locked-in” Consumers Should Meet Exacting Requirements**

Generally, courts have found that consumer preferences can only support narrower markets where a group of consumers are, in effect, incapable of switching in response to price increases. This can occur, for example, where regulatory or other business requirements lock in the range of potential substitutes, or, less frequently, where identifiable consumers affirmatively will not switch under any circumstances to otherwise functional alternatives (e.g.,

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102 Id. at 338.
103 Id.
104 Id.
105 See, e.g., George J. Stigler & Gary S. Becker, *De Gustibus Non Est Disputandum*, 67 Am. Econ. Rev. 76 (1977) (noting that it is unnecessary to resort to ad hoc claims that tastes differ or change over time to explain why consumers may make different choices notwithstanding facing the same market prices).
truly inframarginal consumers).\textsuperscript{106} While this also appeared to be the underlying driver of the \textit{Whole Foods} decision, the application of the principle there was questionable. Whole Foods arguably was unable to price discriminate according to divergent preferences because it could not identify and target for higher prices those customers who had less elastic demand for its product.\textsuperscript{107} Nor were its prices unconstrained by “conventional” supermarkets in geographic markets that lacked a Wild Oats (the acquired company).\textsuperscript{108}

At a minimum, the law is fairly settled that product markets based on price discrimination are only appropriate when a merger eliminates competition between firms for a subset of identifiable customers who cannot easily switch to other products and, therefore, may not be protected by those who could. In order for firms actually to be able to price discriminate, however, they must be capable of isolating that subset of customers who can be forced to pay a higher price.\textsuperscript{109} As a leading antitrust treatise notes, “Successful price discrimina-

\textsuperscript{106} See generally Pitofsky, supra note 90, at 1848 (“The Guidelines and the case law recognize that if a seller or group of sellers can earn substantially different returns from the sale of the same products to different classes of customers, those ‘captive customers’ who cannot or will not switch to other sources of supply may constitute a separate and narrower relevant market.” (footnotes omitted)).

\textsuperscript{107} See, e.g., FTC v. R.R. Donnelley & Sons Co., No. 90-1619 SSH, 1990 WL 193674, at *2 (D.D.C. Aug. 27, 1990) (“For example, despite some individuals’ strong preferences for cola soft drinks over other soft drinks, this court in \textit{Coca Cola} found the relevant product market to consist of all carbonated soft drinks. Likewise, glass and metal containers have been deemed to fall within the same product market, notwithstanding the fact that some end-users (such as pickle producers) prefer to use glass containers. Cadillac automobiles have similarly been deemed to compete against lower priced cars (such as Chevrolets), despite the well-known preferences of some consumers for Cadillas.”); Carell v. Shubert Org., Inc., 104 F. Supp. 2d 236, 264–65 (S.D.N.Y. 2000) (collecting cases and distinguishing “customer preference” from “compulsion” or being “locked-in”) (“Courts in this district have rejected the proposition that allegedly unique products, by virtue of customer preference for that product, are ‘markets unto themselves.’ See, e.g., Global Disc. Travel Servs., LLP v. TWA, Inc., 960 F. Supp. 701, 705 (S.D.N.Y. 1997); Frito-Lay, Inc. v. Bachman Co., 659 F. Supp. 1129, 1137 (S.D.N.Y. 1986) (finding corn chips interchangeable with other salty snacks); Shaw v. Rolex Watch, USA, Inc., 673 F. Supp. 674, 679 (S.D.N.Y. 1987) (finding Rolex watches interchangeable with other high quality watches); Gianna [Enters. v. Miss World (Jersey) Ltd., 551 F. Supp. 1348, 1354 (S.D.N.Y. 1982)] (finding Miss World and Miss Universe pageants are interchangeable with other beauty pageants.)”); see also L.A. Draper & Son v. Wheelabrator-Frye, Inc., 735 F.2d 414, 424 (11th Cir. 1984) (“For proof of sales patterns to support a geographic market definition, we would have to know that consumers could not realistically turn to outside distributors should prices rise within the four-state area.”).

\textsuperscript{108} See supra note 107 (cases); see also David Pettit, Comment, \textit{Submarkets and Supermarkets: FTC v. Whole Foods Market and the Resurrection of Brown Shoe}, 16 GEO. MASON L. REV. 971, 988 (2009).

\textsuperscript{109} See United States v. Rockford Mem’l Corp., 898 F.2d 1278, 1284 (7th Cir. 1990) (“[D]iet soft drinks sold to diabetics are not a relevant product market, but that is because the manufacturers cannot separate their diabetic customers from their other customers and charge the former a higher price. Hospitals can and do distinguish between the patient who wants a coronary bypass and the patient who wants a wart removed from his foot; these services are not in the same product market merely because they have a common provider.”).
ination means that the disfavored geographic or product class is insulated from the favored class and, if the discrimination is of sufficient magnitude, should be counted as a separate relevant market.\textsuperscript{110}

5. Assessing Market Definition Based on Reasonable Interchangeability Has a Sound Basis in Economics

Finally, consistent with the Clayton Act and prevailing Section 7 case law, market definition, including concepts of reasonable interchangeability, remains central to a proper antitrust analysis of a proposed merger. Indeed, the inquiry into the competitive effects of a proposed horizontal merger can be answered reliably \textit{only} by identifying all of the constraints that collectively constrain price in the line of commerce at issue. As Franklin Fisher has observed, “[M]arket definition should be considered an organizational first step in antitrust analysis . . . . The constraints on [the exercise of market] power are what are to be examined, and market definition should be a summary of what one has to understand to analyze what is going on.”\textsuperscript{111}

A thorough understanding and evaluation of the constraints the merging parties face is necessary in order to make a credible assessment of whether the merged firm would have the ability to increase prices above the competitive level.\textsuperscript{112} Constraints are imposed both by demand substitutability (other goods and services to which customers can easily turn), and by supply substitutability (the ability of other sellers to begin producing substitutable products). That some constraints are individually more significant or more direct than others is irrelevant; it is the \textit{totality} of the constraints on price (and non-price aspects of competition) that must be measured and addressed to define the relevant market.

Even though these bedrock interchangeability principles have become ingrained in antitrust jurisprudence, the 2010 Guidelines would appear to seek out short cuts, ignoring the warning that “[i]f market definition departs from the study of constraints on power . . . and becomes a word game or focuses on the way the plaintiff views the business, then the exercise becomes positively harmful.”\textsuperscript{113} Market definition, however, should not be viewed as merely another tool in the toolkit or an unwelcome hurdle to address when challenging a merger in court; rather, it provides the Agencies and practitioners with a disciplined method for identifying and calibrating the strength of competition

\textsuperscript{110} 2B \textsc{Phillip E. Areeda} \& \textsc{Herbert Hovenkamp}, \textit{Antitrust Law} ¶ 534d (3d ed. 2007).
\textsuperscript{112} Or, more generally, reduce non-price forms of competition, such as product quality and innovation, below the competitive level.
imposed by other sources on the merging parties’ products. Further, and perhaps most critically, market definition provides a reality check on the plausibility of “direct” evidence of likely competitive effects, thereby ensuring better informed decisions and avoiding false positives.114

The 2010 Guidelines’ departure from the fundamental market definition principles of the 1992 Guidelines and prevailing case law has attracted criticism from leading antitrust economists, including two former deputy assistant attorneys general. As Dennis Carlton has observed, “Any suggestion that the courts should abandon the use of market definition when analyzing the competitive effects of mergers is unwise, as the failure to define markets would likely increase the number of erroneous decisions reached by courts.”115 Robert Willig, who led the development of the 1992 Guidelines, similarly explained that “[t]he purpose behind a requirement of market definition and assessment of shares is the imperative for disciplined consideration of sources of competition beyond the parties’ own products, along with the need to generate a consistent calibration of the strength of that additional competition.”116

B. THE INSERTION OF UPP INTO THE HMT IS INCONSISTENT WITH THE REASONABLE INTERCHANGEABILITY PRINCIPLE

Perhaps because the Agencies do not embrace the judicial standard of reasonable interchangeability for defining relevant markets, the 2010 Merger Guidelines have modified the HMT (using UPP) in ways that distance Agency analysis from that traditionally employed by the courts. Here, again, some history is in order.

1. The HMT Under the 1992 Guidelines Attempted to Capture Reasonable Interchangeability, But with Artificially Narrow Results

In its simplest form, the HMT is an analytical construct in which the Agencies seek to define the “smallest” relevant market in which the merging parties compete. Under the 1992 version of the HMT, the Agencies would start with each of the merging firm’s products, begin adding closest substitutes, and ask whether, for that candidate product market, a hypothetical monopolist could

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114 See, e.g., Dennis W. Carlton, Market Definition: Use and Abuse, COMPETITION POL’Y INT’L, Spring 2007, at 3, 4 (“Although some may call for the elimination of the [market definition] methodology as an analytic tool because of its limitations, its great strength is that it may prevent decisionmakers from making egregious errors.”).


profitably impose a SSNIP. Importantly, as Shapiro explains, the 1992 HMT was an “iterative algorithm” that added “next best substitutes” to the “candidate market,” but halted the exercise once the smallest market principle was satisfied.117

The 1992 HMT attempted to define markets involving differentiated products, but had three perceived flaws. First, it was frequently difficult to implement because, though elegant in concept, typically there were very little hard data to carry out the exercise. Second, from a Section 7 defendant’s perspective, the HMT tended to define markets very narrowly, especially where the products were differentiated.118 Thus, notwithstanding that the HMT was supposed to “identify” reasonably interchangeable products, these often were excluded. And, third, from the Agencies’ perspective, the 1992 HMT could lead to the perverse result of the merging firms not even having “competing” products in the same “market”—e.g., when the parties are each other’s “third” closest competitor, but the SSNIP test would define a market around first and second order substitutes.119

The 1992 version of the HMT, with its particular combination of defining the smallest market around “own elasticity” of a candidate combination of products, received a mixed reception in court: accepted as a conceptual mat-

117 Shapiro, From Hedgehog to Fox, supra note 1, at 88. The HMT framework of the 1992 Guidelines was enhanced by the introduction of “critical loss” analysis, which attempts to determine whether the likely loss in sales volume from a hypothetical price increase (i.e., the own elasticity of the products in the candidate “market”) is less than the “critical loss”—the volume of sales that the hypothetical monopolist would have to lose (given a specified margin) for the postulated price increase to be unprofitable. See generally Daniel P. O’Brien & Abraham L. Wickelgren, A Critical Analysis of Critical Loss Analysis, 71 ANTITRUST L.J. 161 (2003) (citing Barry C. Harris & Joseph J. Simons, Focusing Market Definition: How Much Substitution Is Necessary? RES. L. & ECON. 12, 207–26 (1989)). A critical loss analysis is especially complicated by the need to assess own elasticities; moreover, much like UPP, it must either hold demand and supply responses constant or assume they are incorporated into a diversion assessment. In any event, UPP is not dependant on an assessment of own elasticity. See discussion infra Part II.B.2.

118 See, e.g., 4 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 913a (3d ed. 2009) (recognizing the difficulty of market definition in unilateral effects cases because “[e]ven if a narrow market definition would be appropriate, it may be more difficult to identify “clear breaks in the chain of substitutes” sufficient to justify bright-line marker boundaries”’ (citation omitted)); see also United States v. Gillette Co., 828 F. Supp. 78, 81–83 (D.D.C. 1993) (demonstrating the difficulty of properly defining a narrow market in connection with a candidate market for “refillable fountain pens with a [suggested retail price] of between $50 and $400” (internal quotation marks omitted)); In re Super Premium Ice Cream Distribution Antitrust Litig., 691 F. Supp. 1262, 1268 (N.D. Cal. 1988) (“Courts have repeatedly rejected efforts to define markets by price variances or product quality variances. Such distinctions are economically meaningless where the differences are actually a spectrum of price and quality differences.” (emphasis omitted)), aff’d sub nom. Haagen-Dazs Co. v. Double Rainbow Gourmet Ice Creams, Inc., 895 F.2d 1417 (9th Cir. 1990) (unpublished table decision).

119 2006 Commentary, supra note 20, at 6; Shapiro, From Hedgehog to Fox, supra note 1, at 87–89.
ter, but often rejected on the real world facts before the court. Even among those citing the HMT favorably since its introduction in 1982, few actually considered the test in detail, and we are not aware of any cases in which the HMT has been adopted as the exclusive test for market definition.

The courts’ reluctance to embrace the HMT as the primary framework for market definition analysis may reflect the fact that aspects of the HMT are potentially inconsistent with the reasonable interchangeability standard. As formulated in the 1992 Guidelines, the HMT necessarily begins with a postulated market of the products of two particular firms, rather than determining demand-side substitutes by looking at functional close substitutes, cross-elasticity (or some estimate thereof), and own price elasticity of demand. As discussed above, courts have consistently determined the potential for anticompetitive effects in a relevant line of commerce by considering some combination of all of these concepts, with no one economic tool being dispositive. Other courts have rejected reliance on the HMT because of the difficulty of finding credible evidence to perform the SSNIP calculations.

The court’s decision in SunGard is informative on the issue, observing that “[f]rom this [HMT] evidence, one can only surmise that there are some customers that cannot switch to an internal solution in response to a SSNIP of shared hot sites, nor can they make a credible threat to switch in order to keep the merged company from raising prices.” The court, however, rejected the use of the HMT because the government “failed . . . to show whether this captive group is substantial enough that a hypothetical monopolist would find it profitable to impose such an increase in price.” The court in FTC v. Swedish Match was equally unpersuaded by evidence put forth by either the FTC or the defendants related to the HMT, and considered other factors to determine the relevant market. Of course, these courts did not reject the concept of HMT; rather, they found it immaterial to the facts before them.


121 See, e.g., Malaney v. UAL Corp., No. 3:10-CV-02858-RS, 2010 WL 3790296, at *6 (N.D. Cal. Sept. 27, 2010); United States v. Oracle Corp., 331 F. Supp. 2d 1098, 1111–12 (N.D. Cal. 2004); California v. Sutter Health Sys., 130 F. Supp. 2d 1109, 1120 (N.D. Cal. 2001); Werden, supra note 120, at 264 (observing that no court has ruled that HMT cannot be used to define a market); see also FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109, 120–21 & n.7 (D.D.C. 2004) (coming closer than most cases to describing HMT as the primary test for market definition, but ultimately defining the market based on substitutability).


123 Id. at 191–92.

124 131 F. Supp. 2d 151, 161 (D.D.C. 2000) (noting that competing economic models for calculating profitability undermined the persuasiveness of the data put forth by the parties) (“Dr. Simpson’s use of the Lerner Index [to calculate whether a SSNIP would be profitable] in this
Finally, even courts that have used the HMT in their analyses have dealt with some of the HMT’s inherent flaws by considering the closeness of all available substitutes. For instance, in FTC v. Arch Coal, Inc., both parties used the HMT to justify their proposed market definition. The court considered the data from the HMT (and found it relevant), but ultimately defined the market based on substitutability:

In order for 8800 Btu coal to be considered a separate relevant market, plaintiffs must show that 8800 Btu coal is not interchangeable with 8400 Btu coal. The testimony of Dr. Morris does not satisfy that burden, because he does not account for the substantial evidence regarding the purchasing practices of utilities, which establishes that 8800 and 8400 Btu coal are substitutable. In both trial testimony and depositions, virtually all the utilities acknowledged that they can and do purchase and consume both 8800 and 8400 Btu coal, and that they actively solicit and consider both in their coal bidding procedures.125

The court was unwilling to use the HMT to avoid precedent requiring that market definition reflect functional substitutability. The court in Whole Foods was equally unwilling to rely solely on the HMT. The court discussed the HMT analysis, but also considered evidence from both sides related to industry perceptions, including “deposition testimony from other supermarkets [that] indicated they regarded Whole Foods and Wild Oats as critical competition [and] [i]nternal documents from the two defendants [that] reflected their extensive monitoring of other supermarkets’ prices as well as each other’s.”126

2. The 2010 UPP Version of the HMT Appears to Discard Reasonable Interchangeability Altogether

In any event, while not receiving much attention in the vast commentary on the new Guidelines, the case law on the HMT has effectively been rendered obsolete under the 2010 Guidelines; unlike in the iterative HMT market definition exercise, the revised Guidelines remove the concepts of critical loss and own elasticity, or the adding of next best substitutes in the HMT iterative process. In its place, the Guidelines appear to insert a UPP screen in the HMT exercise,127 which is likely to result in defining “markets” that fall well short of encompassing “the full range of substitutes from which customers choose.”128 Indeed, the 2010 Guidelines expressly acknowledge that, under the UPP version of HMT, the Agencies “may identify a group of products as a
relevant market even if customers would substitute significantly to products outside that group in response to a price increase."

To understand this sweeping change in the HMT under the new Guidelines, consider what a UPP screen implies for the following merger hypothetical. At the intersection of two busy roads, two gasoline stations sit. Other stations densely populate both roads and the surrounding vicinity. The two stations at the intersection propose to merge. As one prominent economist has noted, "A two-station, one-intersection market would be laughed out of court—and properly, I would think." Yet, at a minimum, a UPP screen (now incorporated in the HMT exercise) certainly invites this implausible market definition. Because each of the merging stations is each other’s (geographically) closest competitor, the sales diverted between the stations would very likely be substantial. And because the stations must cover their fixed costs of doing business (e.g., rent on the land and buildings they occupy), each would need to earn a reasonable margin above the wholesale price of gasoline. By focusing exclusively on the value of diverted sales under static assumptions, the application of a UPP screen would very likely find a two-station, one-intersection market. Most antitrust practitioners would expect that competition from "outside" this artificially defined market would make anything beyond de minimis postmerger price increases unsustainable, especially over the “foreseeable future” time horizon contemplated by the HMT. However, the 2010 HMT would support such a market because it is definitionally incapable of accounting for either dynamic supply responses or merger efficiencies to rebut the math of a UPP screen.

While this simple merger hypothetical illustrates the incredibly narrow market definitions that we fear will become commonplace under the revised Guidelines, the uncertainty embodied in the 2010 Guidelines runs much deeper. As we discuss toward the end of Part III below, the combination of UPP’s well-recognized limitations (both practical and theoretical) and the 2010 Guidelines’ conspicuous silence as to how the Agencies will “weigh” a positive UPP screen result against supply responses (repositioning, expansion, and entry) and merger efficiencies, makes UPP an unreliable and unproven basis for identifying anticompetitive mergers.

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129 Id.
131 Id.
132 The merger may allow the stations to reduce their fixed costs, but it is unlikely to lower the wholesale price of gasoline, which is the principal variable cost facing both stations. Thus, there is unlikely to be any significant variable cost efficiency—to the extent relevant—to offset the gross upward pricing pressure implied by this hypothetical merger.
133 See 2010 Guidelines, supra note 2, § 4.0.
134 See discussion infra Part III.D.4.
3. A UPP-Based Version of the HMT Is Not a Reliable Economic Tool for Defining Product Markets

Incorporating UPP into the HMT analysis also raises serious questions as to whether HMT can offer a proven or reliable basis for defining narrow product markets. With regard to differentiated products, defenders of the 2010 Guidelines assert that, in general, the “HMT provides a well-defined and coherent method for delineating the relevant market.”135 But this may fail to consider some of the practical implications of the HMT with a UPP twist. Indeed, most recently, the court in Group Health questioned the application of UPP to supplement (or replace) a standard market definition analysis.136

Based on the Agencies’ commitment to UPP—revealed more clearly in Shapiro’s article than in the 2010 Guidelines themselves—the HMT/UPP debate will be a long one. For example, Shapiro writes that “[a] group of products can form a relevant market under the HMT even if there is significant substitution between that group of products and other products,” observing that “[a]s a result, properly defined antitrust markets often exclude some substitutes to which some customers might turn in the face of a price increase even if such substitutes provide alternatives for those customers.”137 Although Shapiro views this result as “follow[ing] from the economic logic of the HMT,”138 we see the disconnect to practical marketplace reality as a flaw in the HMT’s usefulness as a tool for making real-world enforcement decisions, especially with a UPP screen as the boundary-defining tool in the HMT exercise. Certainly, it is reasonable to be skeptical of the claim that “[t]he HMT [from the 2010 Guidelines] provides a well-defined and coherent method for delineating the relevant market.”139 In fact, the insertion of UPP into the HMT would seem to make the HMT an even less reliable basis for defining relevant markets when that exercise is given particular prominence in the Agencies’ toolkit.

The problem with using UPP in the HMT exercise lies in the assumptions and ambiguity of UPP itself. UPP seeks to measure the added profit potential from a price increase resulting from a proposed merger. To be sure, by drawing attention to one way in which a merger combining sellers of differentiated products may affect their pricing incentives, UPP offers a potentially valuable insight. For example, a particular high UPP might signal the need to look particularly closely at the reasons for industry margin levels, the closeness of

135 Shapiro, From Hedgehog to Fox, supra note 1, at 86.
137 Shapiro, From Hedgehog to Fox, supra note 1, at 86 (emphasis added) (citation omitted).
138 Id. at 87.
139 Id. at 86.
demand alternatives, or likely supply responses in the event of a postmerger unilateral price increase. However, by assigning particular prominence to one element of the overall competitive analysis—without offering clear guidance as to how the Agencies will calibrate this tool against the other essential analytical elements (foremost, supply responses and merger efficiencies)—the UPP screen does not provide reliable or clear guidance. Shapiro acknowledges UPP’s limitations as a screen, observing that while it “can be highly informative . . . [it] typically is not the end of the story.”

As many appropriately observe, however, the most significant concerns raised about using a UPP screen receive no direct mention in the 2010 Guidelines and, therefore, may not be fully appreciated—or understood as constraints—by users of the Guidelines, including the Agencies themselves.

We remain concerned by three issues of significance. First, the Agencies have embraced UPP as their primary tool for the HMT analysis (and for assessing unilateral effects), notwithstanding its lack of real-world validation. We find this approach problematic, and we agree with commentators who have suggested that UPP’s status as an untested approach makes it an unsuitable starting point for merger analysis.

Second, UPP’s predictions rest on assumptions about critical parameters (diversion ratios and price/cost margins) that are not so easily measured. And, third, by focusing on static demand-side issues, a UPP screen offers neither reliable nor robust guidance about likely merger effects. Absent a track record of successful prediction of postmerger price effects, a UPP screen also lacks the demonstrated scientific validity, reliability, and robustness that courts routinely demand when evaluating economic analysis.

As a predictive tool, UPP’s lack of demonstrated reliability as a screen is compounded by the fact that it relies on key parameters that typically require considerable care to measure (or estimate) and interpret reliably in the context of merger reviews. While a diversion ratio may be relatively straightforward to define in principle, in practice, the estimation of likely diversion between the merging parties raises issues of data quality, estimation robustness, and appropriate interpretation that cannot be minimized. While Shapiro acknowl-

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140 Shapiro, Remarks for ABA Section of Antitrust Law Fall Forum, supra note 15, at 26.
141 Other competition authorities have expressly adopted distinct thresholds or safe harbors for the use of UPP as a screen, but suffer from the same overselling of UPP to prove likely price effects. See infra notes 164–166 and accompanying text.
142 See, e.g., Carlton, Comment on Proposed Horizontal Merger Guidelines, supra note 115, at 13 (“[T]he use of UPP as a merger screen is untested; to my knowledge, there is no empirical analysis that has been performed to validate its predictive value in assessing the competitive effects of mergers.”).
143 In Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579 (1993), the Supreme Court required trial judges to serve in a gate-keeping role by reaching a preliminary assessment of whether expert testimony is “scientifically valid.” Id. at 592–93, 597.
edges these issues, he suggests that “an investigation focusing on the extent of
direct competition between the merging parties can be usefully structured
around diversion ratios even if it is not possible to measure the diversion ratio
with precision.”

We are far less sanguine. At a minimum, evidence about
the closeness of competitors inferred from estimated diversion ratios needs to
be supplemented and validated by examining the underlying economic factors
capable of explaining whether or why the products at issue may be especially
close and durable substitutes. Absent independent validation—which can
come from an assessment of the products’ relevant attributes (and their func-
tional interchangeability), the delineation of the requisite assets to provide
those attributes, and the identification of firms that possess (or could readily
obtain) those requisite assets—an estimated “high” diversion ratio lacks pre-
dictive reliability as a screen in merger review.

Consider, for example, some of the practical limitations of estimating diver-
sion ratios from real-world data. Shapiro has proposed that diversion ratios
may be estimated “using evidence generated in the merging firms’ normal
course of business,” such as win-loss records, customer surveys, or internal
company documents. In practice, estimating diversion ratios raises signifi-
cant difficulties. One common approach to estimating diversion ratios as-
sumes that sales divert in proportion to firms’ market shares. As has been
widely recognized, however, using market shares as a proxy for diversion
requires first properly defining a relevant market—a crucial step that UPP
otherwise avoids. The use of market share proxies also unrealistically assumes
that all products in the market are equally close to each other, notwithstanding
differentiation among products. An equally problematic limitation of the pro-
portional diversion approach is that it ignores postmerger repositioning that
dampens potential incentives to raise prices. In fact, any measure of diversion
associated with current shares necessarily fails to account for repositioning
and thus overstates the likelihood of a postmerger price increase.

Nor are several alternative diversion measures immune from significant es-
timation issues. Consider win-loss records as one frequently proposed alterna-
tive. Premerger records may show sales gained and lost for reasons other than
relative price changes or other competition-related factors. Moreover, like
share-based measures, diversion estimates based on historical win-loss

144 Shapiro, From Hedgehog to Fox, supra note 1, at 60 n.39.
145 See Marius Schwartz & George Rozanski, Comments on: Horizontal Merger Guidelines for
146 Farrell & Shapiro, Antitrust Evaluation of Horizontal Mergers, supra note 4, at 18.
147 By focusing more on structure than effects, the use of market shares to estimate diversion
rates would also raise the same concerns that Shapiro has associated with the “hedgehog” mode
of analysis. See Shapiro, From Hedgehog to Fox, supra note 1.
records do not indicate how close the next best substitute is and do not account for postmerger repositioning; for both reasons, win-loss data may present a distorted picture of the competitive constraints on the merged firm.

Natural experiments are potentially informative, but they too must be used extremely carefully as a basis to infer likely product diversion. The price increase associated with a natural experiment (e.g., a factory fire) may be smaller or less sustained than the appropriate threshold to apply in merger review. In such cases, the observed diversion to firms other than the merger partner will likely fail to account appropriately for repositioning by suppliers or search and adaptation by consumers and thus will likely overstate the extent to which the merger partner would recapture diverted sales.

Customer surveys—another proposed data source to estimate diversion—may pose complex hypotheticals that indicate little about the merger’s likely effects on prices or may artificially limit the set of permitted survey responses relative to the diversity of choices available to consumers. When faced with an unfamiliar hypothetical, a surveyed consumer might express greater reluctance to switch to seemingly less similar alternatives than his actual product choices would indicate when he is confronted with a real-world change in relative prices.

As one final example, internal company documents may highlight only a subset of the firm’s competitors and may give rise to the suggestion that competition is narrower—and thus diversion to the merger partner would be greater—than a more complete analysis would confirm. Indeed, the Agencies alluded to this concern and its potential associated bias in their Commentary on the Horizontal Merger Guidelines, observing that “‘markets’ in common business usage do not always coincide with ‘markets’ in an antitrust context.”

While receiving somewhat less attention than diversion ratios, a UPP screen also requires accurate and reliable measurement of price/cost margins. However, rarely does such measurement prove to be a straightforward task in practice. Margins may appear high simply because they have been mea-

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148 2006 Commentary, supra note 20, at 12. Important limitations associated with each of these sources of information have prompted some to favor econometric analysis of pricing and sales data to directly estimate own-price and cross-price elasticities (thus bypassing UPP altogether). Where robust data are available, these more sophisticated methods are generally preferred. But this exercise requires reliable data and appropriate econometric methods and assumptions, often involves a great deal of time and considerable expense, and even then such approaches are not immune to manipulation or false positives.

149 See, e.g., Michael G. Baumann & Paul E. Godek, Margin of Error: The Flawed Paradigm in the New Merger Guidelines, CPI ANTITRUST CHRON., Spring 2011, Vol. 3, No. 1, at 10 (arguing that the Agencies should not expect “firms to manage their records in accordance with the definitions of economic theory” as it relates to measurement of price/cost margins).
sured incorrectly. The central problem is that the economic concepts that underlie marginal or incremental cost rarely equate to the accounting cost concepts that underlie companies’ financial reporting.\textsuperscript{150} And, as we discuss in detail below, reliable measurement of price/cost margins is especially challenging in dynamic markets with ongoing innovation and repositioning that leads to product differentiation.\textsuperscript{151} In sum, reliably estimating diversion and measuring gross margins need not be—and often are not—straightforward undertakings.

Perhaps anticipating many of these and other practical difficulties in applying UPP, the Agencies drafted the revised Guidelines with sufficient plasticity—including as it relates to the HMT—to ensure that the Agencies’ new toolkit could be used flexibly depending on the industry and available data. While that same flexibility is reflected in the new Guidelines’ assessment of unilateral effects, any use of UPP by the Agencies to ‘prove’ anticompetitive effects would be particularly troubling.

III. “UNILATERAL EFFECTS”: THE COURTS VERSUS THE GUIDELINES’ “FOX”

One of the most significant changes in the 2010 Guidelines is the Agencies’ adoption of UPP for assessing unilateral effects. Although UPP is explicitly referenced only once in the 2010 Guidelines themselves, Shapiro’s article makes clear that the “triumph of the fox” culminates with the application of UPP to predict whether a merger between competitors will provide an incremental incentive to raise prices on one or more of the merged firm’s products. For the reasons we discuss in detail below, it will be difficult for UPP to survive judicial scrutiny as a merger enforcement tool for assessing competitive effects.

A. WHAT THE 2010 GUIDELINES AND SHAPIRO SAY ABOUT UNILATERAL EFFECTS AND UPP

As the 2010 Guidelines and Shapiro’s article make clear, unilateral effects have played an increasing role in the Agencies’ merger reviews. Thus, we believe the unilateral effects section of the 2010 Guidelines—with its inclusion of, and allusions to, UPP—is one of the most significant revisions to the Guidelines. Further, it is clear from the Guidelines, and Shapiro’s description of unilateral effects, that the viability of the UPP screen as an economic—and


\textsuperscript{151} See discussion \textit{infra} Part IV.C.
legal—tool will be at the heart of any debate on future application of the 2010 Guidelines for assessing unilateral effects.\textsuperscript{152}

Given the critical importance of UPP as explained by Shapiro, it is surprising that the Guidelines themselves do not more transparently lay out the UPP screen’s assumptions, limitations, or application. Instead, the sole express reference to UPP in the Guidelines is as follows:

Adverse unilateral price effects can arise when the merger gives the merged entity an incentive to raise the price of a product previously sold by one merging firm and thereby divert sales to products previously sold by the other merging firm, boosting the profits on the latter products. Taking as given other prices and product offerings, that boost to profits is equal to the value to the merged firm of the sales diverted to those products. The value of sales diverted to a product is equal to the number of units diverted to that product multiplied by the margin between price and incremental cost on that product. In some cases, where sufficient information is available, the Agencies assess the value of diverted sales, which can serve as an indicator of the upward pricing pressure on the first product resulting from the merger. Diagnosing unilateral price effects based on the value of diverted sales need not rely on market definition or the calculation of market shares and concentration.\textsuperscript{153}

However, elsewhere in the Guidelines, UPP’s presence is apparent from references to “the value of diverted sales” and the concomitant “incentives” that these sales may reflect. From this perspective, we see UPP indirectly infusing many aspects of the Guidelines, including the “overview” itself (Section 1), the discussion of sources of evidence (Section 2.2), market definition (Section 4.1.1–4.1.3 and Examples 5 and 6), and, of course, unilateral effects (Section 6.1 and Example 19, which builds on Example 5).\textsuperscript{154}

The Agencies apparently believe that the “value of diverted sales” provides them with a tool to identify those mergers involving differentiated products that result in an increased incentive to raise prices (or reduce quality or variety). By way of example, Shapiro explains the basic analysis as follows:

To see how common ownership changes incentives, it is a bit easier to think in terms of the incentives to sell more units of Product 1 (the reverse of raising the price of Product 1). Owning Product 2 creates a disincentive to sell more units of Product 1. Suppose that for every four extra units sold of

\textsuperscript{152} Of course, whether an economic formula or model is a viable tool for economists is a separate inquiry from whether it can or should be a viable legal tool for courts. See 4 AREEDA & HOVENKAMP, supra note 118, ¶ 913a (noting that the methodology of considering unilateral effects without market definition “is quite sensible for the economist, whatever its legal limitations may be”).

\textsuperscript{153} 2010 Guidelines, supra note 2, § 6.1 (emphasis added).

\textsuperscript{154} Id. §§ 1, 2.2, 4.1.1–4.1.3, 6.1.
Product 1 by lowering its price, one fewer unit of Product 2 is sold. This corresponds to a diversion ratio of 25 percent. The higher the diversion ratio, the greater the disincentive to sell units of Product 1 created by the merger. So far so good, as per the 1992 Guidelines. The logical—and unavoidable—next step is to ask how cannibalizing sales of Product 2 affects the merged firm’s profits from selling more units of Product 1. Lost unit sales of Product 2 only affect the merged firm’s profits to the extent that those sales were contributing to profits, i.e., to the extent that price exceeds marginal cost for Product 2. This directs our attention to the gap between price and marginal cost for Product 2. This is just arithmetic.155

But whether the UPP screen can survive judicial scrutiny is a whole other matter.

B. FROM AN EFFECTS PERSPECTIVE, A UPP SCREEN WITHOUT MORE SCRUTINY IS INCONSISTENT WITH THE 1950 AMENDMENTS TO SECTION 7

There is a legitimate question as to whether the entire premise of the UPP screen—with its focus solely on the merging parties—is even consistent with Section 7 itself. As Brown Shoe explains in detail, Congress amended Section 7 to remove the statutory language that focused potential anticompetitive effects on the reduction in competition that exists solely between the merging parties. The Court explained:

Section 7 of the Clayton Act, prior to its amendment, focused upon this aspect of horizontal combinations by proscribing acquisitions which might result in a lessening of competition between the acquiring and the acquired companies. The 1950 amendments made plain Congress’ intent that the validity of such combinations was to be gauged on a broader scale: their effect on competition generally in an economically significant market.156

Thus, in 1950, Congress altered the statute to focus on harm to an overall market rather than merely the reduction in competition between the merging parties themselves. As we have detailed above, in adopting the 1950 amendments to Section 7, Congress expressly embraced the reasoning of the International Shoe case, which held that, absent a harm to competition “generally,” the mere reduction of competition between the merging parties cannot support a Section 7 violation.157

Contrary to this requirement, however, the UPP screen focuses narrowly on the loss of competition between the merging parties. Perhaps a UPP screen could still be consistent with the 1950 amendment to Section 7 if there were some express threshold or other objective criteria to ensure that the Agencies

155 Shapiro, From Hedgehog to Fox, supra note 1, at 71–72.

156 Brown Shoe Co. v. United States, 370 U.S. 294, 335 (1962) (footnote omitted).

157 See supra notes 39–43 and accompanying text.
applied UPP to identify likely harm in an economically meaningful market or at least with focus broader than just on “competition” that exists between the merging parties. But the 2010 Guidelines do not appear to include any concentration or market share screen for UPP that may act as a governor on the Agencies’ prosecutorial discretion.\[158\] Indeed, Shapiro highlights that the 2010 Guidelines specifically omit the 35 percent market share threshold of the 1992 Guidelines (above which unilateral effects were presumed).\[159\] In the Agencies’ view, the 35 percent threshold was never meant to suggest a safe harbor, and Shapiro explains that the UPP screen may indicate likely harmful effects at much lower combined shares—a rationale that presumably justifies the Agencies apparently discarding any HHI threshold for unilateral effects as well.\[160\] For example, even though the Agencies increased the HHI thresholds in the revised Merger Guidelines to more closely reflect current practices, Shapiro acknowledges that the “DOJ puts far more weight on diversion ratios and margins . . . than on the HHI level when diagnosing unilateral price effects,” which seemingly neutralizes the practical significance of the increased HHI thresholds.\[161\] At some point the Agencies and revised Merger Guidelines should make clear that parties need only satisfy a “safe harbor”—either HHI or some objective UPP threshold—to resolve competitive concerns early in a merger investigation.\[162\]

Accordingly, the UPP screen’s potential defect from a statutory perspective runs deeper than its estrangement from a “relevant market”—i.e., by definition, a UPP screen necessarily indicates a likely anticompetitive effect any time two competitors merge, and there is no express safeguard enumerated in the 2010 Guidelines to restrain the Agencies from threatening to launch an extended investigation or bring a case based on UPP analysis alone. As a matter of policy, any screen that inevitably indicates an adverse effect of some degree cannot provide reliable “guidance” for parties attempting to pursue a merger between competitors. Although the Agencies often state that the UPP screen will only be invoked against mergers of “substantial competitors,” this,


\[159\] Shapiro, From Hedgehog to Fox, supra note 1, at 68 (“The express acknowledgement that HHI levels typically are not very helpful diagnostics in [unilateral effects] cases has led to concerns that the valuable screening role played by the HHI thresholds since 1982 has been reduced or lost.”).

\[160\] Id.

\[161\] Id.

\[162\] By making this suggestion we do not mean to endorse the notion that a UPP indication above any safe harbor warrants a presumption of effects or can constitute proof of a Section 7 violation.
too, is not what the statute provides. Whether invoked against substantial competitors or not, this type of potential per se “anticompetitive effect”—even as an investigatory “tool”—is contrary to the 1950 amendment to Section 7 itself.

In other jurisdictions, the enforcement agencies have been clearer about how they use UPP. For example, the UK Competition Commission and Office of Fair Trading’s (OFT) recently issued Merger Assessment Guidelines adopt UPP as an analytical tool for assessing differentiated products mergers. While these agencies eschew an express safe harbor for UPP, they do adopt a rebuttable presumption for a UPP indication. As a recent OFT enforcement decision makes clear, the presumption from a UPP indication:

may be rebutted, by the OFT itself or by the parties, on the basis of evidence suggesting a contrary interpretation: for example, that the parties are not, in fact, close competitors pre-merger despite this evidence, or that other rivals are close third and fourth choices for diverting customers, or that countervailing constraints from supply-side responses (entry, expansion or repositioning) or buyer power would discipline away any such incentive to worsen the merged firm’s offer post-merger.

We do not endorse a rebuttable presumption attached to UPP—for the reasons expressed in this article, there is no reason to raise UPP to the level of a Philadelphia National Bank-like presumption. But at least the OFT has made clear how it is using UPP in its overall analysis, including assessing the closeness of non-merging rivals, supply responses, and merger efficiencies as factors to rebut a UPP presumption.

C. Even Without Considering Supply Responses, a UPP Screen Cannot Withstand Judicial Scrutiny

Separate and apart from the direct conflict with the 1950 amendment to Section 7, the UPP screen is contrary to the limited case law that addresses unilateral effects. For example, the Agencies cannot dispute that a UPP screen suggests anticompetitive effects to some degree for every horizontal merger of competitors as a matter of simple “arithmetic.” Shapiro acknowledges this,
but asserts that the UPP screen will only be used as an “indicator” of a likely anticompetitive effect. However, because the UPP screen always shows an effect, the 2010 Guidelines offer no definitive guidance on how mergers for which the screen indicates upward price pressure may survive enforcement review, which in turn leaves the business and legal community without a reliable basis for making decisions or providing advice regarding transactions that may be subject to Section 7 scrutiny. Likewise, as we describe below, the UPP screen is incapable of providing reliable guidance to a court attempting to assess whether a proposed transaction may have a likely “unilateral” anticompetitive effect in any line of commerce.

1. If the “Arithmetic” Always Indicates an Adverse Effect, There Is a Problem

Perhaps the most troubling fact about the UPP screen is that the arithmetic inevitably shows that a merger involving differentiated products indicates a price increase on one or more of the parties’ products. This is because UPP is merely the product of a diversion ratio and a margin—both of which will necessarily be positive if the merging parties are competitors and one of the products has a positive margin. Thus, under the UPP screen, any degree of cross-elasticity between the products of the merging parties—which essentially equates with a diversion ratio—indicates upward price pressure. Indeed, even where products may be viewed as “distant” competitors with what would be considered low cross-elasticity for market definition purposes, the UPP screen will still indicate postmerger upward pricing pressure. It is self-evidently difficult to provide business and legal decision-makers with a reliable guide to the likely effects of their proposed transactions.

Shapiro, envisaged applying a default efficiencies credit, generally suggested to be 10 percent. The efficiencies credit was to apply as a “standard deduction,” meaning that merging parties would receive an automatic credit to reflect evidence that mergers typically generate cognizable efficiencies. Farrell & Shapiro, Antitrust Evaluation of Horizontal Mergers, supra note 4, at 10; see also discussion infra Parts IV.B–IV.C.

169 See Shapiro, From Hedgehog to Fox, supra note 1, at 76.


171 If the merging parties are treated symmetrically and if prices are equal across the merging firms, the GUPPI may be expressed as the product of the diversion ratio and the variable margin on the merger partner’s product. See Farrell & Shapiro, Antitrust Evaluation of Horizontal Mergers, supra note 4, at 27.

172 While Shapiro suggests that this analysis is just a variation of established direct effects analysis, in the Section 7 context that notion is consistently rejected. See supra note 50 and accompanying text (requiring market definition in the face of the FTC’s attempt to establish a Section 7 violation without defining a market). And, direct evidence is infrequently used in the Section 2 context, though it is occasionally relied upon, if available. See, e.g., PepsiCo, Inc. v. Coca-Cola Co., 315 F.3d 101, 107–08 (2d Cir. 2002). But see In re Comp. of Managerial, Prof’l & Technical Emps. Antitrust Litig., Nos. MDL 1471, 02-CV-2924 (GEB), 2006 WL 361383, at *1–2 (D.N.J. Feb. 15, 2006) (collecting cases) (holding that where “a plaintiff can show that a defendant’s conduct exerted an actual adverse effect on competition, [which] is a strong indicator
dent—and, we think, uncontroversial—that an uncalibrated tool cannot have predictive value as a screen if it always indicates postmerger price pressure. But neither UPP nor the 2010 Guidelines offer this vital calibration.

Moreover, UPP offers little or no transparency in predicting the magnitude of a merger’s effect on price—a point acknowledged by Shapiro. Nor is the requisite calibration provided by the Guidelines’ statement that “[i]f the value of diverted sales is proportionately small, significant unilateral price effects are unlikely”; “[f]or 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.” While the Guidelines do not attempt to quantify this statement, Shapiro has proposed that a Gross Upward Pricing Pressure Index (GUPPI) of less than 5 percent of lost sales would qualify as “proportionately small” under the Guidelines.

Yet, consider, for example, an industry with nine identical firms, each making a product that is functionally and reasonably interchangeable with the other eight. Assume further that the firms earn 50 percent gross margins over their marginal costs and that, if prices for all their products rose by a small but significant amount, then collectively they would cede 20 percent of their sales to other firms. Now suppose that two of the nine firms decide to merge. These hypothetical facts would trigger a GUPPI indication of anticompetitive effects using a 5 percent of lost sales threshold—even though the overwhelming preponderance of lost sales would be diverted to non-merging suppliers.

This “UPP presumption” results from an analysis that seeks to avoid the discipline of market definition and the constraints imposed by express calibration against likely supply responses and efficiencies. Accordingly, what is most striking about UPP is what, by definition, it cannot account for and, in fact, masks, absent further modification. For example, UPP predicts postmerger price pressure without regard to the number and quality of reasonably interchangeable products, the ability and likelihood of consumers to switch to functional alternatives, or the ability and likelihood of suppliers to reposition of market power, and ‘arguably is more direct evidence of market power than calculations of elusive market share figures’ . . . [p]laintiffs would [nonetheless] have to prove the relevant product market, even if they use the direct evidence method to prove their claims” (second alteration in original) (citation omitted)). See also Republic Tobacco Co. v. N. Atl. Trading Co., 381 F.3d 717, 736, 738 (7th Cir. 2004) (rejecting plaintiff’s reliance on direct effects evidence to avoid market definition in the context of a vertical agreement).

of market power[,] and ‘arguably is more direct evidence of market power than calculations of elusive market share figures[,]’ . . . [p]laintiffs would [nonetheless] have to prove the relevant product market, even if they use the direct evidence method to prove their claims” (second alteration in original) (citation omitted)). See also Republic Tobacco Co. v. N. Atl. Trading Co., 381 F.3d 717, 736, 738 (7th Cir. 2004) (rejecting plaintiff’s reliance on direct effects evidence to avoid market definition in the context of a vertical agreement).

173 See Shapiro, From Hedgehog to Fox, supra note 1, at 76 (“The value of diverted sales, taken alone, does not purport to quantify the magnitude of any post-merger price increase.”).

174 2010 Guidelines, supra note 2, § 6.1 & n.11.

175 Shapiro, Remarks for ABA Section of Antitrust Law Fall Forum, supra note 15, at 24.

176 In this symmetric example, diversion between the merging parties would be 10 percent. If margins were 50 percent, and if prices were equal across the merging firms, then GUPPI would be exactly at the proposed 5 percent threshold.
their product offerings. It would be similar to—and in fact worse than—the Agencies arguing that an HHI violation necessarily predicts a Section 7 violation, something the courts have long rejected. The only difference with the UPP screen is that the Agencies have made it generally much easier to find a UPP effect rather than an HHI violation, which gives rise to our concern that UPP will become an overused tool for asserting proof of anticompetitive effects.

Many commentators have observed that UPP—in part to combat the inevitable indicated price “effect”—originally incorporated an efficiencies “credit” (not adopted in the 2010 Guidelines). But even with a 10 percent efficiencies credit, a UPP screen would indicate price effects in situations involving seven equally situated premerger firms with margins as low as 35 to 40 percent. Thus, UPP would suggest condemning 7-to-6 mergers where margins would be considered moderate. These are mergers that almost certainly would have avoided enforcement action in the past. We are unaware of any evidence from merger retrospectives or postmerger enforcement suggesting that most or many of those mergers, in fact, led to anticompetitive price increases. Furthermore, it is readily apparent that the UPP screen also would indicate strong anticompetitive effects for a number of merger challenges that the Agencies lost in court. As Joseph Simons and Malcolm Coate have noted,

177 See, e.g., FTC v. Butterworth Health Corp., 946 F. Supp. 1285, 1295 (W.D. Mich. 1996) (noting that the court was persuaded by the defendant’s statistical evidence that non-profit hospitals do not necessarily raise prices when their markets become more concentrated), aff’d, 121 F.3d 708 (6th Cir. 1997) (unpublished table decision); see also Chi. Bridge & Iron Co. v. FTC, 534 F.3d 410, 432 (5th Cir. 2008) (noting that HHIs should not be considered dispositive of competitive harm from a merger).

178 See Gopal Das Varma, Will Use of the Upward Pricing Pressure Test Lead to an Increase in the Level of Merger Enforcement?, ANTITRUST, Fall 2009, at 27 (showing, based on simulation experiments, that “a sizable proportion of mergers that create a UPP presumption do not create a structural presumption”).


180 In this symmetric example, diversion between the merging parties would be about 17 percent. If margins were 40 percent, and if prices were equal across the merging firms, then the UPP index would be about 11, which exceeds an assumed 10 percent efficiencies credit. Note that the minimum efficiencies credit required to prevent upward pricing pressure (measured as a percentage of premerger marginal cost) is itself a function of the firms’ margins, with higher margins necessitating a larger percentage efficiencies offset to neutralize upward pricing pressure.


182 For example, the following cases that the Agencies lost no doubt would have high UPP indications: FTC v. Butterworth Health Corp., 121 F.3d 708, 1997 WL 420543 (6th Cir. 1997) (unpublished table decision) (affirming denial of injunction against merger where market share would go from 47 percent to 65 percent); United States v. Baker Hughes Inc., 908 F.2d 981 (D.C. Cir. 1990) (finding no Section 7 violation even where postmerger market share exceeded 75 percent); United States v. Waste Mgmt., Inc., 743 F.2d 976 (2d Cir. 1984) (reversing grant of
the UPP screen “identifies as potentially problematic far more mergers than would be challenged or even investigated under the enforcement standards that have existed for more than twenty years.”

The approach is even more worrisome when the UPP screen is applied without an express efficiencies credit, as it is in the 2010 Guidelines. Consider, for example, the Los Angeles grocery market at issue in *United States v. Von’s Grocery Co.* If a 10 percent efficiencies credit were applied to the market shares at issue there, then a UPP screen would not have implied upward pricing pressure unless Vons’ gross margin exceeded 71 percent and the gross margin of the other merging party, Shopping Bag Food Stores, exceeded 65 percent. There is no reasonable likelihood that the firms would have earned margins this high. By contrast, without any efficiency credit, a UPP screen would have indicated upward pricing pressure even though the merged grocery store had less than a 10 percent market share. In other words, the UPP screen as incorporated in the Guidelines would have provided a basis to condemn a merger that clearly was not anticompetitive. In the real world, Vons’ eventually became part of Safeway—the largest grocer in Los Angeles when *Von’s Grocery* was decided—and the grocery market in Los Angeles remains intensely competitive today.

2. **UPP Is Indifferent to the Closeness of Competition Between Merging Parties, Which Is Contrary to the Case Law**

Having embraced the UPP screen as a primary analytical framework for unilateral effects analysis, the Agencies had to decide what to do with the part

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183 Simons & Coate, supra note 179, at 389.
185 For the purposes of this exercise we assume that diversion in *Von’s Grocery* was proportional to market shares.
186 See Harkrider, supra note 158, at 1 (“[T]he newest iteration of the Merger Guidelines potentially returns us to the days of *Von’s Grocery*, when businesses are unable to determine with any degree of certainty whether particular mergers are likely to be challenged by the Government.”).
187 See generally From *Von’s* to Schwinn to the Chicago School: Interview with Judge Richard Posner, Seventh Circuit Court of Appeals, Antitrust, Spring 1992, at 4, 5 (noting that although then-assistant to the Solicitor General Richard Posner argued *Von’s Grocery* for the government before the Supreme Court, Judge Posner has since stated that he is no longer comfortable with the Justice Department’s arguments in *Von’s* and that, in retrospect, “the Von’s merger was completely harmless”); see also Jerry Hirsch, *Groceries: More Price Cuts on the Way*, L.A. Times, Sept. 2, 2009, at 1. Los Angeles is served by at least five major supermarket chains, including Kroger’s, Safeway, Stater Bros., SuperValu, and Whole Foods Markets, as well as clubs stores Target, Wal-Mart, and many local/regional chains.
of the 1992 Guidelines that focused on whether the products of the merging parties were the “first and second choices” of a significant group of customers. If the UPP screen governs, then all that matters is that the merging parties have a competitive relationship with each other—i.e., some premerger “diversion” that may be “internalized” by the merger according to the “value” predicted by UPP. As we illustrated in the preceding section, a 5 percent UPP screen can easily capture mergers between firms that are not particularly close competitors. It is not surprising, therefore, that the 2010 Guidelines expressly state that the merging parties need not be each other’s closest substitute.188

From the perspective of the courts, however, it may be difficult to abandon the concept that for a unilateral effects theory the merging parties must be close substitutes.189 Indeed, based in large part on the unilateral effects cases brought by the Agencies under the 1992 Guidelines’ framework, the law is now clear that the merging parties must, at a minimum, uniquely occupy a product space if the government realistically hopes to prove a Section 7 violation under a unilateral effects theory.

Oracle remains the leading unilateral effects case on differentiated products, and will not be easily avoided in attempts to challenge future mergers under the new Guidelines.190 Oracle involved the Department of Justice’s Section 7 challenge to Oracle’s tender offer for PeopleSoft, Inc. on the grounds that the two firms dominated the market for a type of enterprise application software, known as enterprise resource planning (ERP) system software.191 A

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188 Compare 2010 Guidelines, supra note 2, § 6.1 (“Substantial unilateral price elevation post-merger for a product formerly sold by one of the merging firms normally requires that a significant fraction of the customers purchasing that product view products formerly sold by the other merging firm as their next-best choice.” (emphasis added)), with 1992 Guidelines, supra note 5, § 2.21 (“Substantial unilateral price elevation in a market for differentiated products requires that there be a significant share of sales in the market accounted for by consumers who regard the products of the merging firms as their first and second choices . . . .”). See Shapiro, From Hedgehog to Fox, supra note 1, at 68 (“In a merger joining Products 1 and 2, significant unilateral effects for Product 1 can occur even if Product 2 is not the ‘closest substitute’ overall to Product 1.”).

189 The courts’ continued focus on close substitutes may be one explanation for the Agencies’ inclusion of Example 6 in the 2010 Guidelines. Example 6 tempers Example 5’s problematic statement that sales of two competing products can satisfy HMT “even though two-thirds of the sales lost by one product when it raises its price are diverted to products outside the relevant market.” 2010 Guidelines, supra note 2, § 4.1.1 ex. 5. Example 6 then hedges, noting that if, for example, half of the diverted sales following a merger are diverted to a third product, then that product “will normally be included in the relevant market.” Id. ex. 6. While this recognition of other potential competitors that could restrain price is welcome, the “will normally be included” language provides insufficient assurance for merging parties that close substitutes will in fact be included in the Agencies’ analysis if doing so makes it more difficult for them to bring a challenge to a particular merger.


191 See id. at 1100–09. In addition to the DOJ, several states were also involved in bringing the action challenging the Oracle/PeopleSoft merger. Id. at 1100.
consumer purchases ERP software to integrate most of its data across all or most of its activities, such as human resources or supply chain management. The DOJ limited its claims against Oracle to ERP software capable of meeting the needs of large and complex enterprises, claiming that only Oracle and PeopleSoft supplied this narrowly drawn software market. In rejecting the DOJ’s challenge to Oracle’s acquisition, the court provided one of the most instructive opinions to date on unilateral effects. Although the court relied on several grounds, a significant portion of the decision focused on the DOJ’s failure to prove its unilateral effects claim because it proffered insufficient evidence to support its argument that the merger would adversely affect competition in the localized market—or “node”—for the software at issue.

In this respect, Judge Vaughn Walker’s analysis was clearly influenced by the presence of SAP as a significant competitor in the market with Oracle and PeopleSoft. While the court recognized that the 1992 Guidelines emphasized the relative closeness of a buyer’s first and second choices, it held that “the relative closeness of the buyer’s other choices must also be considered in analyzing the potential for price increases.” In other words, even the factors described in the 1992 Guidelines were “not sufficient to describe a unilateral effects claim.” Instead, the court required that a “plaintiff must prove not only that the merging firms produce close substitutes but also that other options available to the buyer are so different that the merging firms likely will not be constrained from acting anticompetitively.” The court then outlined four necessary components of a unilateral effects claim, including that “other products must be sufficiently different from the products controlled by the merging firms that a merger would make a small but significant and non-transitory price increase profitable for the merging firms,” and that “repositioning by the non-merging firms must be unlikely.” Applying these requirements, the court found that the DOJ had “wholly failed” to

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192 Id. at 1101, 1107.
193 Id. at 1166–73. The other three grounds for the court’s holding were: first, the government’s evidence was insufficient to demonstrate a relevant product market limited to financial management systems and human relations management software sold by Oracle and PeopleSoft because a properly defined market included mid-market vendors, outsourcing, and other solutions; second, the DOJ incorrectly argued the geographic market was the United States when it was in fact a worldwide market; and third, the government’s evidence was insufficient to demonstrate Oracle’s postmerger ability to tacitly coordinate and allocate customers, as required to show the merger’s purported coordinated effects. Id. at 1158–61, 1164–66.
194 Id. at 1117.
195 Id.
196 Id.
197 Id. at 1117–18. The other two factors Oracle stated as a requirement of the government or a plaintiff making a unilateral effects claim were, “[f]irst, the products controlled by the merging firms must be differentiated,” and “[s]econd, the products controlled by the merging firms must be close substitutes.” Id. at 1117.
demonstrate unilateral effects because it failed to show an area of “localized competition.”

*FTC v. CCC Holdings Inc.* further confirms the importance of close substitutes in differentiated products unilateral effects cases, and it did so when the FTC used a simulation analysis in court that was an extension of UPP. In *CCC Holdings*, the district court granted a preliminary injunction to halt a 3-to-2 merger in the market for specialized software used by insurers and automobile repair shops to estimate the cost of replacement or repair in the event of a partial or total loss of an automobile. The court rejected the FTC’s assertion that 3-to-2 mergers are always subject to a preliminary injunction, but nevertheless found that given “the way these markets operate in fact,” particularly with high entry barriers, the FTC had established a strong prima facie case that raised serious questions relating to the proposed merger’s potential for coordinated effects.

With respect to unilateral effects and the application of a UPP-styled analysis, however, the FTC suffered a significant setback. CCC had an estimated 35 percent share and the other party, Mitchell’s, share was 26.5 percent. The largest provider was Audatex, with a 38.5 percent share. The FTC relied on a simulation model to predict postmerger price increases of approximately 15 to 20 percent. The FTC’s simulation model always predicted a price effect whenever Audatex was the third alternative in any particular bid event.

The cross-examination (both by counsel and the court) at the *CCC Holdings* preliminary injunction hearing exposed the significant limitations of this analysis. For example, the testimony established that the FTC could offer no reliable direct information on the extent to which buyers regard Audatex as a close or distant substitute to the merging parties’ software. Testimony further established that the government could not “put a precise number on how much less attractive” some customers may have viewed Audatex’s product. Lacking direct information on the products’ relative positioning or buyers’ views

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198 Id. at 1172; see also id. at 1167 (“In trying to prove Oracle and PeopleSoft are in localized competition, plaintiffs tried to downplay SAP’s presence in the United States and characterize SAP has being ‘disadvantaged’ and unable to enter several markets. But plaintiffs’ own evidence on market shares negates such a finding.”).


200 Id. at 46.

201 Transcript of Evidentiary Hearing at 10 (Jan. 21, 2009), *CCC Holdings*, 605 F. Supp. 2d 26 (No. 08-2043).

202 Id. at 31.

203 Id. at 32, 34.

204 Id. at 36. For a very small portion of industry sales, the FTC offered some limited information gleaned from customer statements ranking software products, but even for these relatively few customers, no data were available to measure the gap between Audatex and the merging firms’ products. Id. at 35–36, 52.
regarding product closeness, the FTC was forced to extrapolate from market shares and gross margins to deduce price effects. Relying on the price effects predicted by its model, the FTC contended that a significant number of buyers must regard Audatex as only a very distant substitute for the merging firms’ products. Ultimately, the court concluded that “[t]he main problem with [the government’s] models is that the data and predictions cannot reasonably be confirmed by the evidence on this record.”

Moreover, much like how we anticipate UPP will fare in litigation, the court in CCC Holdings found that the FTC’s simulation analysis ignored important competitive realities. For example, the court rejected the FTC’s use of predicted price effects to infer the closeness of substitute products, rather than relying on actual evidence about products’ closeness to analyze whether the merger would lead to higher prices. Indeed, the mechanics of the FTC’s simulation analysis all but ensured predicted price increases given that the three largest firms earned similar margins, on the order of 80 percent. Moreover, notwithstanding the fact that Audatex was the top choice of more customers than either of the merging firms, the FTC asserted that Audatex was a distant third in the eyes of many customers. The FTC’s analysis also ignored the potential for repositioning by Audatex or other competitors by assuming that postmerger shares were identical to premerger shares. The court rejected this approach, holding that “the absence of any evidence of identifiable characteristics of these firms’ products or their customers that might make Audatex a more distant third option makes it impossible to reach the conclusion that Audatex is a more distant third choice.” Similar attempts to use UPP—with its equally simplifying assumptions—are likely to meet a similar fate in court.

3. A UPP Screen Will Tend to Protect Mere Customer Preference

One complication in discussing the proper role of consumer preferences is that there are few cases (save Oracle) that deal with consumer preferences as

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205 Id. at 36–37.
206 CCC Holdings, 605 F. Supp. 2d at 70.
208 Transcript of Evidentiary Hearing, supra note 201, at 34, 54. In software and other high-technology industries, of course, “high” gross margins are not unusual, and elsewhere Shapiro has appropriately cautioned against drawing inferences that antitrust market power exists solely on the basis of “high” gross margins. Carl Shapiro, Antitrust, Innovation, and Intellectual Property, Testimony Before the Antitrust Modernization Commission 7 (Nov. 8, 2005) [hereinafter Antitrust, Innovation, and Intellectual Property], available at http://faculty.haas.berkeley.edu/shapiro/amcinnovation.pdf.
209 Transcript of Evidentiary Hearing, supra note 201, at 38, 42.
210 Id. at 28–29.
211 CCC Holdings, 605 F. Supp. 2d at 72.
they relate to competitive effects. This lack of judicial authority is itself telling. Most cases in which consumer preferences play a very prominent a role are decided on market definition and resolved before an effects analysis even comes into play.212 Yet, on the subject of effects, the 2010 Guidelines appear to embrace the protection of consumer “preferences.” Thus, the Guidelines imply that the UPP screen is an analytical tool that can protect certain customers merely because they prefer the products of one of the merging parties at premerger prices.213

The Agencies’ tendency—perhaps precipitated by the logical implications of UPP—to protect discrete consumer preferences conflicts with established Section 7 law. While claims regarding consumer preferences are typically confined to—and rejected—in the context of market definition, Oracle made clear that a distinct “node” or “an area of localized competition” cannot be based on consumer preferences.214 As the court found, not only is the protection of simple consumer preference an improper motivation for defining narrow markets, it also is inappropriate as a component of an effects analysis.215

4. The Guidelines’ Application of UPP Screening to Non-price Competition Is Even More Suspect

As reflected in the 2010 Guidelines, the Agencies extended the use of UPP—which is most frequently applied to price competition—to other forms of rivalry. Perhaps given that UPP is a formulaic application of diversion ratios and margins, the Agencies apparently felt it could be applied to other possible reasons for “diversion.” Hence, both the 2010 Guidelines and Shapiro suggest that the UPP screen can (and potentially will) be applied to “non-price” unilateral effects, such as a loss in product quality or “variety.”216 The Guidelines contemplate predicting what diversion ratios result from changes in product quality or variety (how that might be done is left largely unexplained), and then would apply the UPP logic to that diversion.217 If our reading is correct, this suggests that the Agencies are postulating Section 7

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212 As discussed above, the few courts that consider consumer preferences in the market definition exercise are, more accurately, assessing functional interchangeability rather than simple consumer preference. See discussion supra Parts II.A.3–II.A.4.

213 See 2010 Guidelines, supra note 2, § 6.1.


215 See Oracle, 331 F. Supp. 2d at 1131, 1172.

216 See Shapiro, From Hedgehog to Fox, supra note 1, at 62 (“[T]he very same concepts can be applied to non-price competition.”); 2010 Guidelines, supra note 2, § 6.4.

217 See 2010 Guidelines, supra note 2, § 6.4 (“An anticompetitive incentive to eliminate a product as a result of the merger is greater and more likely, the larger is the share of profits from that product coming at the expense of profits from products sold by the merger partner.”).
violations on the somewhat startling prospect that a merger may result in a non-price change to just one of the merging parties’ products, regardless of the breadth of the product offerings of the parties or their competitors. As with the UPP screen applied to potential price increases, however, this proposition suffers from the defect that any planned or potential postmerger change in product offering could bring about a “diversion,” and thus result in pressure to eliminate a product. More importantly, this variation of a UPP screen also is premised entirely on protecting particular consumer preferences, which, as discussed above, is the opposite of the intent of Section 7 or the antitrust laws.

Using UPP to screen for non-price competition is particularly suspect when we observe that the simple UPP index is premised on a static economic model (a topic we take up below), whereas non-price competition certainly is not static. Moreover, differentiated product mergers particularly “affect non-price competition, [for which] effects can be more important than pricing effects.” Although we applaud the recognition of this reality, the Agencies’ proposed application of a UPP screen—particularly in light of its very limited track record—is not a good test for evaluating the repercussions of mergers on non-price competition.

5. UPP’s Reliance on Margins Penalizes Innovation and Competition Through Differentiation

Under a UPP screen, firms with greater margins are automatically subjected to heightened scrutiny because (all else equal) they will necessarily have higher UPP results any time they merge with a competitor. Shapiro’s comments on this topic do not resolve this concern. He writes that high margins do not in and of themselves raise antitrust concerns, pointing to industries that have high R&D costs; and the 2010 Guidelines echo this point. Likewise, high margins may reflect the quality-adjusted price of intensive competition.

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218 At a minimum, more complex formulations of UPP must be employed to move outside the simple static setting; yet, this would come at the expense of the simplicity and parsimonious informational requirements that UPP was intended to offer.


220 Shapiro has previously recognized the danger that antitrust enforcement can deter innovation. In 2005 he explained that “it is an error to infer genuine antitrust market power based on the gap between price and marginal cost,” and such an “error may be more common or more pronounced in innovative industries.” Shapiro, Antitrust, Innovation, and Intellectual Property, *supra* note 208, at 7. “The key point to bear in mind here,” he explained, “is that the competitive price can easily and significantly exceed marginal cost.” Id. Shapiro wrote that “the Commission might play a useful role by emphasizing these economic principles in order to help [c]ourts improve the accuracy and sophistication of their antitrust analysis in innovative industries.” Id.

221 2010 Guidelines, *supra* note 2, § 2.2.1 & n.3.
based itself on product differentiation—something generally viewed as procompetitive.\(^{222}\)

The 2010 Guidelines and the UPP screen, however, provide no mechanism to avoid the inevitable penalization of firms whose margins reflect desirable innovation leading to competition through product differentiation. Indeed, in such industries—pharmaceuticals, telecommunications, and computer software, for example—margins are typically quite “high,” which means that the likelihood of an adverse UPP test result also will be high.\(^{223}\) A de facto penalty for innovators is particularly problematic given, first, the sizeable consumer benefits of innovation,\(^{224}\) and, second, the fact that projections of future industry conditions tend to be more challenging and speculative—and thus much less reliable—in dynamic, highly innovative industries.\(^{225}\)

The logic underlying the recognition of potential special circumstances in innovative industries pervades other areas of antitrust analysis as well, further calling into question what may very well be a penalty on innovation. Several courts, for example, have recognized that rapidly changing markets and technologies can lead to competition through innovation for temporary market leadership, until another technology or product repositions itself or becomes practically interchangeable for the same use.\(^{226}\) The Agencies seemed to recognize this principle early on in the drafting process,\(^{227}\) but the 2010 Guidelines do not account for these marketplace realities.

\(^{222}\) See id.

\(^{223}\) See McDavid & Stock, supra note 24, at 4–5 (noting their concern that the 2010 Guidelines will lead to increased enforcement activity in the pharmaceutical and high-tech industries based solely on high margins).

\(^{224}\) Shapiro, Antitrust, Innovation, and Intellectual Property, supra note 208, at 2 (“[A]t least over the medium to long term, the lion’s share of consumer benefits associated with competition in our most dynamic industries results from innovation.”).

\(^{225}\) See id.

\(^{226}\) See, e.g., United States v. Microsoft Corp., 253 F.3d 34, 49 (D.C. Cir. 2001) (“Rapid technological change leads to markets in which ‘firms compete through innovation for temporary market dominance, from which they may be displaced by the next wave of product advancements.’” (citation omitted)); United States v. SunGard Data Sys., Inc., 172 F. Supp. 2d 172, 188 (D.D.C. 2001) (“Thus, although plaintiff has frequently attempted to classify the product market as an oligopoly that the proposed acquisition would shrink to a duopoly, the record leaves little doubt that SunGard and Comdisco consider internal solutions, including internal hot sites, as their main competitive threat and that, in fact, there is increasing evidence that their perception is fully justified in view of the decreasing cost and changing nature of the technology.”); FTC v. R.R. Donnelley & Sons Co., No. 90-1619 SSH, 1990 WL 193674, at *4 (D.D.C. Aug. 27, 1990) (finding that the market definition should be expanded because the ability of a substitute product to compete “will be enhanced in the future because of further technological and market developments”).

6. A UPP Screen Does Not Offer Reliable or Robust Merger Guidance

Shapiro has described UPP as “simple and well-rooted in economics” and “based directly on the underlying economics of pricing.” As we have noted above, we certainly do not disagree with the insight that, in theory, the merging parties may consider the value of diverted sales in their pricing behavior. But the Guidelines’ adoption of UPP for merger screening ascribes unwarranted prominence to a tool that lacks real-world validation and inadequately captures important competitive dynamics. In light of the extremely light record before the courts, it is premature, at best, to embrace UPP as a screening device for merger review.

While UPP describes a firm’s potential incentive to raise price following a merger, it is silent about the likelihood that the merged firm will, in fact, be able to do so. As Shapiro acknowledges, the detection of “upward pricing pressure” incentives, standing alone, cannot resolve whether merging parties will likely escape the real-world thicket of demand-side and supply-side constraints to succeed in raising price. The courts, as well, understand this issue. In reversing the FTC’s decision in Schering-Plough Corp., the Eleventh Circuit held:

The Commission is quite comfortable with assenting to [the economic expert’s] rather amorphous “incentive” theory despite its lack of empirical foundation. Unfortunately, [the economic expert’s] so-called incentives do not rise to the level of legal conclusions. . . . The simple presence of economic motive weighs little on the scale of probative value.

This issue is heightened by some of the theoretical assumptions underlying UPP. The standard UPP formulation adopts the assumption of Bertrand pricing behavior. Although the Bertrand pricing assumption has strong theoretical foundations, it is important not to forget its limitations as a characterization of how competition occurs in the real world. In particular, the Bertrand model is static in the sense that firms are assumed to make simultaneous pricing decisions, recognizing the interdependence of their decisions on current demand, yet ignoring the dynamic repercussions of their decisions. This limitation makes a UPP screen poorly suited to address important issues of dynamic

tion generates enormous value for consumers over the long run. A revision could move the Guidelines into the 21st century by explaining how the Agencies account for market dynamics, the procompetitive role of disruptive entrants, and a merger’s effect on innovation.”


229 Farrell & Shapiro, Antitrust Evaluation of Horizontal Mergers, supra note 4, at 2.


231 Schering-Plough Corp. v. FTC, 402 F.3d 1056, 1069 (11th Cir. 2005) (footnote omitted).
competition by which firms may adjust their postmerger product offerings, brand positioning, and price points.

While Shapiro has proposed a more general articulation of UPP, which would relax the strictures of the Bertrand pricing assumption, this alternative formulation continues to suffer from a critical defect if used as a merger screen—namely, its sensitivity to the choice among alternative theories of pricing behavior. As one commentator has observed, the results from the more general UPP formulation “depend on the specific oligopoly model that actually applies to the industry,” while UPP cannot offer guidance on “precisely what oligopoly model best applies to an industry.”

D. UNILATERAL EFFECTS MUST ACCOUNT FOR DYNAMIC COMPETITION, INCLUDING SUPPLY RESPONSES

Equally troubling is that the Agencies can find a likely anticompetitive effect without considering supply responses, including simple expansion or “repositioning” by competitors with respect to price or non-price dimensions of competition. The UPP screen by definition holds constant as a “given” the prices, products, and potential reactions of others in the marketplace no matter how “close” or distant they are in product space to the products of the merging parties. Instead, the Guidelines provide that potential supply responses will be treated under the Guidelines’ general entry standard of “timely, likely, and sufficient” (and the attendant high hurdles that the Agencies continue to maintain for these arguments).

As we describe below, the Guidelines’ failure to account properly for likely repositioning in response to asserted UPP effects is especially problematic given the case law and marketplace realities. Indeed, contrary to the stated objective of the 2010 Guidelines, UPP (as a static tool) is incapable of identifying or measuring substantial and sustained anticompetitive effects under Section 7.

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232 Carlton, Comment on Proposed Horizontal Merger Guidelines, supra note 115, at 15.

233 See, e.g., James Langenfeld, 2010 Horizontal Merger Guidelines: Changes in Policy, Transparency, & Predictability, CPI ANTITRUST CHRON., Autumn 2010, Vol. 10, No. 2, at 11 (describing evidence in the literature expressing concern that by allowing the Agencies to exclude “smaller rivals” from a calculation of concentration, the 2010 Guidelines “appear to discount a competitive fringe that could expand substantially if there were an attempt to raise price after the merger”).

234 See Shapiro, From Hedgehog to Fox, supra note 1, at 65 (citing 2010 Guidelines, supra note 2, § 6.1).

235 See id. at 54, 65.
1. The UPP Screen Is Static

UPP is a static analytical tool. For example, UPP does not postulate what is likely to occur in the marketplace from either the consumers’ or competitors’ perspective in response to substantial and sustained hypothesized anticompetitive effects. As a matter of law, this makes a UPP screen an improper tool for demonstrating actual proof of a Section 7 violation. Yet, it has long been established in the case law, both in terms of market definition and effects analysis, that the likely reactions of customers and suppliers must be assessed in the face of hypothesized, sustained potential anticompetitive effects. As Hovenkamp has explained:

Excessive reliance on short-run consumer behavior gives us an exaggerated picture to the extent that consumer choice is only one of many avenues along which substitution among products occurs. . . .

. . . These include mainly manufacturers’ ability to re-configure their products in response to higher profits in one segment. Making higher quality baby food may require little more than selecting different ingredients, and perhaps some advertising announcing the quality change. . . .

. . . For example, suppose that a market contains firms A, B, C, D, E & F, and that C and D merge. Why is it that firms A, B, E & F are unable to respond to the C–D price increase? If they cannot make such a response, then it seems reasonable to conclude that they were improperly included in this market to begin with. But if the market were really limited to firms C and D, then we have a simple merger to monopoly, which does not require any “unilateral effects” theory to analyze.236

The Guidelines’ UPP screen, however, admittedly has no mechanism for incorporating the dynamic analysis that the law requires.237

2. Consideration of Supply Responses Is Well Established in the Case Law

The law regarding the role of supply responses to a “unilateral effects” analysis is well established and contrary to a static UPP screen. It is widely accepted that in differentiated product markets, it is common for brands regularly to enter and exit the market or reposition themselves through a variety of strategies.238 In turn, courts routinely discount effects evidence when defendants can show that competitors can reposition their products or show ease of

237 See supra note 66 and infra Part III.D.2 (reviewing the case law employing dynamic analysis for both market definition and effects).
238 See Carl Shapiro, Mergers with Differentiated Products, Remarks Before the ABA and IBA 17 (Nov. 9, 1995) [hereinafter Mergers with Differentiated Products], available at http://www.justice.gov/atr/public/speeches/227167.pdf. These dynamic supply responses complicate the task of estimating diversion rates based on static data. See supra notes 147–148 and accompanying text.
entry.\textsuperscript{239} For example, in \textit{United States v. Gillette Co.},\textsuperscript{240} the court rejected a challenge to the Gillette/Parker Pen transaction largely due to ease of entry and repositioning, observing:

[T]here is ample evidence that the mechanics of fountain pen design are readily available, thus leaving no technological barriers to entry into the market. There are also no legal or regulatory barriers which would preclude competitors from designing and selling premium fountain pens. Although it may take a significant investment of time and money to build market share, the record demonstrates that there are new entrants into the fountain pen market which are able to check increases in price. In addition, given the competition between fountain pens and other modes of writing and the ease with which manufacturers may enter this wider market, Gillette will not be able to raise prices unilaterally on its premium fountain pens.\textsuperscript{241}

Likewise, in \textit{CCC Holdings}, discussed in more detail above,\textsuperscript{242} the court rejected the government’s unilateral effects argument because, in part, it found that the government had provided insufficient evidence to demonstrate that a postmerger unilateral price increase would be profitable.\textsuperscript{243} In particular, the court found no reason to believe that the third largest competitor in the market would be unable or unlikely to reposition itself should the merged company of the two leading firms raise prices to “supracompetitive levels.”\textsuperscript{244}

The court in \textit{Arch Coal} also recognized the importance (and likelihood) of postmerger supply response.\textsuperscript{245} The FTC brought a Section 7 action seeking to enjoin a proposed merger between Arch Coal and another Wyoming coal company on the grounds that the merger was likely to result in future tacit coordination.\textsuperscript{246} Finding that, in such an event, other fringe producers were likely to increase production—particularly if the larger firms coordinated a reduction in output—the court concluded that the defendants had demonstrated that “the ‘fringe’ of the [Southern Powder River Basin coal] market would expand sufficiently to defeat any merger-induced price increase.”\textsuperscript{247} The court also found that fringe producers in the market were “strong companies with credible plans to expand production significantly” and were likely to provide a supply response that would be sufficient to absorb any postmerger increase in demand if the major market participants engaged in a coordinated

\textsuperscript{239} See, e.g., United States v. Engelhard Corp., 970 F. Supp. 1463, 1470–72 (M.D. Ga.), aff’d, 126 F.3d 1302 (11th Cir. 1997).
\textsuperscript{240} 828 F. Supp. 78 (D.D.C. 1993). One of the authors represented Gillette in this case.
\textsuperscript{241} Id. at 84–85 (citation omitted) (footnote omitted).
\textsuperscript{242} See supra notes 199–211 and accompanying text.
\textsuperscript{243} FTC v. CCC Holdings Inc., 605 F. Supp. 2d 26, 72 n.49 (D.D.C. 2009).
\textsuperscript{244} Id.
\textsuperscript{246} Id. at 115.
\textsuperscript{247} Id. at 147 (citing FTC v. H.J. Heinz Co., 246 F.3d 708, 715 (D.C. Cir. 2001)).
lag in production. These cases are just a few among many court decisions considering supply responses, and in particular repositioning, in assessing postmerger effects.

Any discussion of supply responses must also take into account the prospect of de novo entry, which has long played an important role in Section 7 cases. In *United States v. Syufy Enterprises*, the court found that the DOJ’s arguments based on Syufy’s large current market share “attribute[d] far too much importance to this fact[, because] [i]n evaluating monopoly power, it is not market share that counts, but the ability to maintain market share.” Significantly:

The government concede[d] that there are no structural barriers to entry into the market . . . .

Confronted with this record and the district court’s clear findings, the government trots out a shopworn argument we had thought long abandoned: that efficient, aggressive competition is itself a structural barrier to entry. According to the government, competitors will be deterred from entering the market because they could not hope to turn a profit competing against Syufy. . . .

The notion that the supplier of a good or service can monopolize the market simply by being efficient reached high tide in the law 44 years ago in Judge Learned Hand’s opinion in *United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir. 1945). In the intervening decades the wisdom of this notion has been questioned by just about everyone who has taken a close look at it.

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248 *Id.* at 147, 148–49.

249 See also FTC v. Tenet Health Care Corp., 186 F.3d 1045, 1055 (8th Cir. 1999) (“In assessing the ‘commercial realities’ faced by consumers, the district court . . . did not consider the impact of the entry of managed care into the Cape Girardeau market. The evidence shows that managed care has reduced prices in Poplar Bluff and in other markets. A similar downward pressure on prices is now being felt in Cape Girardeau, with the recent entry of managed care into that market.”); United States v. Calmar Inc., 612 F. Supp. 1298, 1306 (D.N.J. 1985) (upholding merger even where HHI would be over 3000) (“The evidence leads to the conclusion that even after the proposed merger the ease of entry into the market would prevent any supplier from exercising market power. A significant sustained price increase most likely would result in a number of reactions in the market. Users either would commence manufacturing their own . . . devices or would enter into a joint venture with someone else to do it or would find another source of supply. Present suppliers would increase production or institute production of the products whose price had been raised. New suppliers would come into the market. Surely Calmar is aware of the likely response to an unjustified price increase and would price its products accordingly.”).

250 903 F.2d 659, 665–66 (9th Cir. 1990) (footnote omitted).

251 *Id.* at 666–68 (citations omitted) (footnote omitted). Subsequently, the Agencies have adopted the “timely, likely, and sufficient” paradigm for assessing entry. See supra note 235 and accompanying text.
Considering all of these facts related to ease of entry, the court was “hard-pressed to see how the district court could have come to the other conclusion.”

3. Merger Guidelines Should Treat Demand and Supply Responses Symmetrically

There is also an important policy point to be made with respect to the Agencies’ adoption of a UPP screen and its inherent assumptions as compared to the strictures that the Guidelines continue to place on taking into account expansion, repositioning, or other supply responses. As a matter of analytical symmetry, there is no apparent reason why the Agencies should rely on UPP to predict that a merged entity has an incentive to raise prices without asking, at the same time, whether competitors would have a corresponding incentive to take advantage of any such actual postmerger conduct. Or, stated more bluntly: Where is the analogous analytical construct to the UPP screen (and its presumed effects) for likely supply responses, including expansion and repositioning? It seems unwarranted to apply assumptions to the UPP screen that are biased toward finding an anticompetitive effect, while at the same time burdening supply responses with the more stringent timely, likely, and sufficient standard used by the Agencies to assess de novo entry.

The Agencies cannot rely on burden-shifting principles to justify a higher standard for those Section 7 defendants that dispute a challenge based on a UPP screen result. As a matter of law, a UPP indication provides no evidence of a Section 7 violation, let alone a presumption that a defendant must rebut. Thus, even though the Guidelines do not expressly articulate what evidentiary value the UPP screen is supposed to represent, neither the 2010 Guidelines nor Shapiro offer any justification for affording the Agencies a shortcut for proving effects through a UPP screen without providing analogous assumptions for crediting likely supply responses.

4. Any Merger Screen that Sets Aside Supply Responses Cannot Be “Robust”

As a matter of economics, as well, one of the most fundamental problems with embracing UPP as a merger screen is its disregard for potential supply responses to actions taken based on the “incentives” to raise price or reduce any non-price competition, postmerger. A UPP screen necessarily ignores all manner of competitive dynamics, including product repositioning (by the merging parties as well as their rivals), introduction of new products and brand extensions, competitor expansion, entry, and efficiencies.

252 903 F.2d at 669.
Notably, during his first tour as Deputy Assistant Attorney General fifteen years ago, Shapiro recognized that in the event of a postmerger price increase, it may well pay for a rival firm to reposition its brand closer to the merging brands. And this threat could well deter the price increase in the first place. . . . Very often in differentiated-product markets, brands enter and exit with some regularity, and existing products may be repositioned either through design changes or revised marketing strategies.253

Notwithstanding these points—which remain no less relevant today than they were a decade and a half ago—the UPP screen incorporates none of these supply responses. Instead, the revised Guidelines all but rule out repositioning in deterring any theoretical “price effect” in the first place. In fact, the Commentary on the Horizontal Merger Guidelines, which was an attempt to provide clarification and discussion of the actual practice of the Agencies in applying the Guidelines and which the Agencies’ current leadership has favorably cited, states:

The Agencies rarely find evidence that repositioning would be sufficient to prevent or reverse what otherwise would be significant anticompetitive unilateral effects from a differentiated products merger. Repositioning of a differentiated product entails altering consumers’ perceptions instead of, or in addition to, altering its physical properties. The former can be difficult, especially with well-established brands, and expensive efforts at doing so typically pose a significant risk of failure and thus may not be undertaken.254

The 2010 Guidelines’ adoption of this view runs directly counter to real-world evidence of successful competitive repositioning in many differentiated consumer products industries. A recent survey catalogued repeated and ongoing instances of repositioning in industries as diverse as retail grocery stores, retail pharmacies, beer, shampoo, and radio broadcasting.255 The survey persuasively demonstrated that these historical examples support the conclusion that significant repositioning can occur as a result of merger-induced price increases, that is, that repositioning will be timely and likely.256 The survey also found that newly introduced brands and product extensions in several of these industries survived for substantial periods of time with quite small shares,257 indicating that for many consumer goods industries the minimum viable scale for repositioning is small.

253 Shapiro, Mergers with Differentiated Products, supra note 238, at 17 (emphasis added).
254 2006 Commentary, supra note 20, at 31 (emphasis added).
256 Id. at 12.
257 Id. at 12–13.
Recognizing the inherently static character of UPP (which lacks similar real-world confirmation), Shapiro acknowledges that “[t]he impact of a merger on pricing incentives might not match up very closely with its impact on innovation incentives” and other non-price forms of competition. Yet, he defends UPP by offering a “parallel test[ ] . . . for different dimensions of competition,” specifically non-price competition. Shapiro’s proposed fix involves defining what is termed an “innovation diversion ratio” that purports to measure the fraction of the extra gross profits earned by one firm when it devotes more resources to innovation at the presumed expense of its merger partner. Shapiro acknowledges, however, that “[t]he innovation diversion ratio in a given case may well be hard to estimate.” And neither Shapiro nor the Guidelines offer specific guidance as to how the Agencies and courts should measure, apply, or interpret the proposed innovation diversion ratio. Since courts are already struggling with the lack of a proven foundation for UPP screening generally—even in the static, price competition setting for which the application of UPP was originally conceived—we anticipate courts would have even greater uncertainty and skepticism about “innovation diversion ratios.”

IV. THE 2010 GUIDELINES CONTINUE TO EXCLUDE EFFICIENCIES AND SYNERGIES FROM ITS “INTEGRATED” ANALYSIS

A. WHAT THE 2010 GUIDELINES SAY ABOUT EFFICIENCIES

In stark contrast to the expansive toolkit for analyzing competitive effects, the 2010 Guidelines remain fairly rigid regarding efficiencies and synergies, failing to recognize progress in economic thinking since the 1997 Revisions to the Merger Guidelines, which revised the 1992 Guidelines’ treatment of efficiencies. In recent years economists, both in private practice and at the Agencies, have sought to develop sound approaches to quantifying efficiencies while also identifying a wide range of merger-specific benefits that can aid consumer welfare. Today, understanding how and why efficiencies from a

258 Farrell & Shapiro, Antitrust Evaluation of Horizontal Mergers, supra note 4, at 33.
259 Id.
260 Id. at 34.
261 See supra note 99.
262 See, e.g., Ken Heyer, Welfare Standards and Merger Analysis: Why Not the Best?, COMPETITION POL'Y INT'L, Autumn 2006, at 29 (arguing for a total welfare standard and explaining why that standard is consistent with antitrust law and legal precedent); Robert Rubinovitz, The Role of Fixed Cost Savings in Merger Analysis, 5 J. COMPETITION L. & ECON. 233 (2009) (discussing the importance of incorporating dynamic efficiencies and fixed cost savings into the competitive effects analysis); William J. Kolasky & Andrew R. Dick, The Merger Guidelines and the Integration of Efficiencies into Antitrust Review of Horizontal Mergers, 71 ANTITRUST L.J. 207 (2003) (discussing the integral role of efficiencies in the competitive effects analysis of
transaction benefit consumers and affect the competitive analysis has become ingrained in Section 7 analysis. We remain hopeful that the Agencies will take account of these fourteen years of learning regarding efficiency and synergy when reviewing proposed mergers.

As in several other areas, the Guidelines acknowledge efficiencies as a critical component of merger analysis but without adequately accounting for the breadth of the subject area. Thus, the Guidelines note that mergers often enhance “the merged firm’s ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products.”263 Unfortunately, however, the Guidelines give insufficient “credit” to a number of efficiencies that now have wide recognition in economic literature as well as proven real-world significance. In this regard, the 2010 Guidelines depart sharply from the conclusions of the Antitrust Modernization Committee, which unequivocally affirmed that all projected cost savings must be evaluated when reviewing a proposed merger’s likely competitive effects.264

For example, the Guidelines explain that “the Agencies consider whether cognizable efficiencies likely would be sufficient to reverse the merger’s potential to harm customers in the relevant market, e.g., by preventing price increases in that market.”265 This statement has the potential to allow for the exclusion, or at least the lessening, of the consideration of non-price effects that provide marked benefits to consumers, such as improved product quality or new products. Similarly, the discussion of fixed cost savings is relegated to a footnote, and even then the Guidelines note that the Agencies primarily credit only short-run efficiencies in cost savings.266 Finally, the Guidelines’ statement that “[t]he Agencies will not deem efficiencies to be merger-specific if they could be attained by practical alternatives that mitigate competitive concerns, such as divestiture or licensing,”267 is unduly restrictive and disconnected from business reality. For instance, although a firm could license a particular technology, a merger may often be a more efficient, welfare-maximizing method of reaching the same result.

263 2010 Guidelines, supra note 2, § 10.
265 2010 Guidelines, supra note 2, § 10.
267 2010 Guidelines, supra note 2, § 10 n.13.
B. EFFICIENCIES ARE BECOMING MORE RELEVANT IN COURT DECISIONS

Despite the 2010 Guidelines’ treatment of efficiencies as a relatively unimportant aspect of merger review, courts clearly have recognized the importance of considering the impact of a merger’s synergies and efficiencies in the relevant market when assessing whether a merger is likely to injure competition.268 Again, it is a matter of analytical symmetry: if the government, or a private antitrust plaintiff, relies on built-in assumptions regarding, for example, price, then antitrust defendants should receive analogous built-in assumptions on the synergies and efficiencies side of the ledger.

_H.J. Heinz_ and _Arch Coal_ provide two of the clearest discussions of efficiencies and essentially follow this reasoning.269 As the D.C. Circuit explained in _Heinz_, “a merger’s primary benefit to the economy is its potential to generate efficiencies.”270 The court cited the 1992 Guidelines’ recognition that “efficiencies ‘can enhance the merged firm’s ability and incentive to compete, which may result in lower prices, improved quality, or new products.’”271 _Arch Coal_ cited the more recent language from the revised 1997 Guidelines, where the Agencies recognized that “‘mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction.’”272

Both courts determined that the standard for using efficiencies to defeat an otherwise valid Section 7 claim would be more difficult to meet when the concentration in the relevant postmerger market was higher, but they returned to the importance of efficiencies considerations.273 Notably, the court in _Arch

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268 See, e.g., 4A Areada & Hovenkamp, supra note 118, ¶ 970c2 (noting efficiencies as one factor that courts will consider in the defendant’s argument for rebutting the government’s prima facie case). In _FTC v. Arch Coal, Inc._, the court considered the role of efficiencies, noting that “[t]he Supreme Court has not sanctioned the use of an efficiencies defense in a case brought under Section 7 of the Clayton Act.” 329 F. Supp. 2d 109, 150 (D.D.C. 2004) (citing _FTC v. Procter & Gamble Co._, 386 U.S. 568, 580 (1967)). However, it is clear that “the trend among lower courts is to recognize the defense.” _FTC v. H.J. Heinz Co._, 246 F.3d 708, 720 (D.C. Cir. 2001) (citing _FTC v. Tenet Health Care Corp._, 186 F.3d 1045, 1054 (8th Cir. 1999); _FTC v. Univ. Health, Inc._, 938 F.2d 1206, 1222 (11th Cir. 1991); _FTC v. Cardinal Health, Inc._, 12 F. Supp. 2d 34, 61 (D.D.C. 1998); _FTC v. Staples, Inc._, 970 F. Supp. 1066, 1088–89 (D.D.C. 1997)).


270 246 F.3d at 720.

271 Id. (quoting 1992 Guidelines, supra note 5, § 4).


273 See id. at 151 (“[E]ven where evidence of efficiencies in the relevant market will not support an outright defense to an anticompetitive merger, such evidence is relevant to the competitive effects analysis of the market required to determine whether the proposed transaction will substantially lessen competition.” (citing _Tenet Health Care_, 186 F.3d at 1054)).
Coal is among those recognizing that a strong efficiencies showing alone can rebut the government’s prima facie case.²⁷⁴ Although problems with the defendant’s statistics rendered its efficiencies showing insufficient to completely rebut the government’s prima facie case in Arch Coal, the court found that the defendant had demonstrated efficiencies of between $35 million and $50 million due to likely “savings from dragline efficiencies, inventory reduction, and equipment sharing between the two mines.”²⁷⁵

Thus, courts have recognized the importance that efficiencies and synergies should play in assessing the postmerger market. After all, such efficiencies are often the practical reason that the companies have sought to merge in the first place. Accordingly, any screening framework—UPP or otherwise—that omits the proper consideration of efficiencies fails not only from a normative perspective but, more importantly, also as a credible tool for analyzing the actual competitive effects of mergers.

C. THE GUIDELINES HAVE WRITTEN EFFICIENCIES OUT OF THE UPP SCREEN

Shapiro acknowledges that the revision to the Guidelines in 1997 reflected an appreciation “that mergers can promote competition by enabling efficiencies, and that such efficiencies can be great enough to reduce or reverse adverse competitive effects that might arise in their absence.”²⁷⁶ He also cites his own 1995 comment that “[a]ny danger of a unilateral price increase may be alleviated by product repositioning, entry, or efficiencies.”²⁷⁷ Although UPP considered efficiencies as one part of the equation, the form of UPP adopted in the 2010 Guidelines does not incorporate this component of the analysis.

As originally conceived, UPP would allow merging firms to apply a “standard deduction” for efficiencies that potentially could mitigate (or even negate) a presumption of upward pricing pressure.²⁷⁸ Shapiro proposed that merging parties would not have to prove merger-specific efficiencies as a precondition to receiving the standard deduction, at least during the initial review period. The standard deduction would be set to a 10 percent reduction in the premerger marginal cost of each merging firm’s product. Notably, however,
the efficiency deduction was strictly limited to “marginal-cost efficiencies” and offered no allowance for fixed cost savings.279

This proposal—an acknowledgment of the problem that, absent merger efficiencies, UPP always predicts upward pricing pressure for any positive price/cost margin and diversion ratio—did not survive the Guidelines’ drafting process. Given the Agencies’ longstanding tendency to marginalize efficiencies, permitting a 10 percent standard deduction for efficiencies (albeit limited to marginal cost savings) would represent a significant departure from recent Agency enforcement.280 Thus, we see no reason to expect that actual enforcement practice under the 2010 Guidelines will apply a “standard deduction” for efficiencies. Eliminating this potential counterweight to the UPP screen, when coupled with the Guidelines’ equally strong skepticism and marginalization of supply-side responses,281 only reinforces the potential for a “heads I win, tails you lose” application of the 2010 Guidelines.

V. IN THE END, THE FOX WILL NOT TRIUMPH

Many have observed that the fox’s toolkit is nothing new. For years, if not longer, Section 7 practitioners have been dealing with diversion ratios, margins, the illusive hunt for demand elasticities, and all of the other quantitative and qualitative tools leading up to the Agencies’ adoption of UPP.282 What is new, however, is the starkness with which the 2010 Guidelines marginalize market definition, re-tool the HMT around UPP, discard any objective thresholds for applying “unilateral effects,” and appear to rely on a UPP screen that is both inconsistent with Section 7 law and incapable of providing practical and reliable enforcement guidance to the business community.

For these reasons, if one wants to look to fox and hedgehog stories for analogies, we offer one—borrowed from a centuries-old Slavonic folktale—that seems more appropriate for predicting how the 2010 Guidelines will fare in court:

A fox meeting a hedgehog asked him, “How many wits have you?” And he replied, “Only three. But how many have you?” “I,” boasted the fox, “have seventy-seven.”

As they were talking and walking along, not noticing whither they were going, they fell into a deep hole which the peasants had dug. The fox asked

279 See supra note 266 and accompanying text (noting the Guidelines’ general hostility towards fixed cost savings).
280 Simons and Coate have noted that Agency “recognition of merger specific marginal cost savings in the range of 10% is rare, if not unprecedented.” Simons & Coate, supra note 179, at 380.
281 See discussion supra notes 66, 233–237, and accompanying text.
the hedgehog to save him. The hedgehog said, “I have only three wits, perhaps you will save me first, then I will see about you afterwards”; and he asked the fox to pitch him out of the hole. The fox did so, and then asked the hedgehog whether he could help him. The hedgehog said, “I cannot help you with three if you cannot help yourself with seventy-seven.” And so the fox was caught in the morning by the peasants and killed.283

Whether Shapiro’s “fox” is cornered by critics of UPP or the courts is beside the point; either way, it is fair to conclude that the “fox” that Shapiro describes may be too clever by half and that, once judicial scrutiny is applied, UPP and the 2010 Guidelines will be in mortal danger.

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