# REWRITING THE HORIZONTAL MERGER GUIDELINES IN THE NAME OF DYNAMIC COMPETITION

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## INTRODUCTION

We favor revision of the Horizontal Merger Guidelines.[1] Our preliminary comments in this essay are based on a work in progress that we provisionally entitle, "Favoring Dynamic Competition over Static Competition." The eventual paper will address, in greater detail than we can explore here, how government enforcement agencies and courts would apply a more explicitly dynamic model of competition to merger analysis. We pose the following question: How must competition policy evolve if it is explicitly to favor Schumpeterian (dynamic) competition over neoclassical (static) competition? Of course, one also could ask that question with respect to intellectual property law and sector-specific regulation of network industries. We intend to do so in our eventual paper.

## I. SCHUMPETERIAN COMPETITION AND MERGER ENFORCEMENT

Schumpeterian competition is engendered by product and process innovation. Such competition does more than bring price competition—it tends to overturn the existing order. A framework for antitrust analysis that favors dynamic over static competition would place less weight on market share and concentration in the assessment of market power and more weight on assessing innovation and enterprise-level capabilities. By embedding recent developments in evolutionary economics and the behavioral theory of the firm into antitrust analysis, one can develop a more robust framework for antitrust economics. Such a framework is likely to ease remaining tensions between antitrust and intellectual property. That framework is also likely to reduce confidence in the traditional tools of antitrust

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[1] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES (1992), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104, *available at* http://www.usdoj.gov/atr/public/guidelines/hmg.pdf.

economics when the business environment manifests rapid technological change.

It appears that, during the George W. Bush administration, the Antitrust Division ("the Division") gravitated toward a more dynamic approach to analysis. In the Oracle-PeopleSoft merger, the Division advocated a narrow market definition that excluded consideration of dynamic competition. The Division lost.[2] By the time of the George Mason Law Review Antitrust Symposium in December 2008, Assistant Attorney General Thomas Barnett argued that innovation is the major source of consumer welfare gain.[3] We agree. Innovation entails the creation of new demand curves for new products, which implies the creation of all the consumer welfare beneath those new demand curves. This accretion of consumer welfare is a bigger prize, roughly by an order of magnitude, than are the fruits from haggling over small Harberger deadweight loss triangles that arise from marginal changes in price along the extant demand curve of an established product.[4] This theme informs the larger debate over Schumpeterian economics—which posits that competition is a dynamic process and firms can compete *for* the market and temporarily achieve a position of dominance. This view of competition is distinguished from static competition in which multiple firms compete simultaneously *in* the market, primarily on the basis of marginal differences in price as opposed to dramatic differences resulting from innovation and quality improvement.

However, the degree to which the Antitrust Division advocated the Schumpeterian vision of competition varied over time and across different doctrinal areas of antitrust law. It remains to be seen whether the Division's advocacy will change course during the Obama administration.

## II. LEGITIMACY VERSUS AUTHORITY: WHY DO THE COURTS AND ENFORCEMENT AGENCIES DENY THAT THE MERGER GUIDELINES BIND THEM?

A complicating factor in the transformation of the law is the fact that the federal courts have, by thoroughly embracing the reasoning of the Horizontal Merger Guidelines as promulgated several decades ago by the Antitrust Division and the Federal Trade Commission ("FTC"), caused antitrust case law to coalesce—some might say ossify—around a decidedly static

2 United States v. Oracle Corp., 331 F. Supp. 2d 1098, 1101 (N.D. Cal. 2004). David J. Teece testified as an expert witness for Oracle. *Id.* at 1157.

3 Thomas O. Barnett, *Maximizing Welfare Through Technological Innovation*, 15 GEO. MASON L. REV. 1191, 1191-94 (2008).

4 The classic empirical analysis is Jerry A. Hausman, *Valuing the Effect of Regulation on New Services in Telecommunications*, 1997 BROOKINGS PAPERS ON ECON. ACTIVITY: MICROECONOMICS 1, 1-3 (measuring the forgone consumer welfare from regulatory delay in the introduction of cell phone service and voicemail).

view of antitrust. Put differently, since 1980 the Division and the FTC successfully persuaded the courts to adopt a more explicitly economic approach, yet one that has a static view of competition.

After three decades, the result is not a mere policy preference that can be altered by speeches or statements of prosecutorial discretion by enforcement officials. Rather, the static view of competition is, by application of the imprimatur of the federal judiciary, the law. Curiously, while it relies on the Guidelines as authority, the D.C. Circuit continues—as recently as the *FTC v. Whole Foods Market, Inc.*[5] decision—to assert that "the Merger Guidelines . . . 'are by no means to be considered binding on the court.'"[6] All of us like to keep our options open, but this kind of statement reduces the intellectual prestige of the judiciary. We see no reason why anyone would find this ipse dixit to be credible.

To an economist—which is to say, one attuned to the information revealed through the evolutionary processes of institutions, including law—the legitimacy of the Merger Guidelines comes from their survival in the face of sustained attempts to refute them. Legitimacy does not arise from the fact that the Guidelines originated as expressions of bureaucratic authority. If the Merger Guidelines were perceived to be intellectually comparable to the guidelines of the Internal Revenue Service, we believe the D.C. Circuit and other federal courts would regard them quite differently.

Consequently, to change the law to embody a more dynamic view of competition will require a sustained intellectual effort by the enforcement agencies (as well as by scholars and practitioners) that, once more, engages the courts to reexamine antitrust law. A necessary but not sufficient condition for that effort is a public process by the Division and the FTC to revisit and restate the Horizontal Merger Guidelines in a manner that clarifies dynamic competition's role in antitrust analysis. Those revised guidelines (and complementary undertakings, such as generalized guidelines on market power and remedies) then will require leadership by the antitrust enforcement agencies to persuade the courts that antitrust doctrine should evolve accordingly. This process may take a decade or longer to accomplish, but that extended timetable is no reason to procrastinate.

## III. THE CONSEQUENTIAL ROLE OF THE MERGER GUIDELINES IN ANTITRUST JURISPRUDENCE

Merger analysis implicates a larger series of issues that are relevant across all of antitrust jurisprudence. For the Obama administration, the *United States v. Microsoft Corp.*[7] case is a useful guidepost for charting

5 548 F.3d 1028 (D.C. Cir. 2008).
6 *Id.* at 1046 (quoting FTC v. PPG Indus., Inc., 798 F.2d 1500, 1503 n.4 (D.C. Cir. 1986)).
7 253 F.3d 34 (D.C. Cir. 2001) (per curiam).

where we have been over the eight years of the George W. Bush administration. The D.C. Circuit's per curiam opinion in *Microsoft* contains an introductory section that asks whether antitrust law is up to the challenge of the "new economy."[8] Before the Internet bubble burst, a debate had arisen over whether high-tech industries could be analyzed under conventional antitrust principles. In a well-read essay, Judge Richard Posner argued that traditional antitrust analysis was competent for the task.[9] In *Microsoft*, the D.C. Circuit agreed.[10] A few pages later, however, the D.C. Circuit seemed to contradict itself. It announced a new and more permissive liability rule for tying arrangements concerning software integration—a rule that repudiated the Supreme Court's ostensibly regnant rule of per se illegality for tie-ins.[11] So troubled was the Supreme Court by the D.C. Circuit's repeal of the per se rule as applied to software integration that the Court denied certiorari.[12]

The Antitrust Modernization Commission ("AMC") report from April 2007 provides a second major example of self-contradiction regarding the need to revise antitrust principles to accommodate consideration of dynamic efficiency.[13] In its summary of recommendations, the AMC said that "[n]o substantial changes to merger enforcement policy are necessary to account for industries in which innovation, intellectual property, and technological change are central features."[14] Nevertheless, the same report recommended two pages later that the Division and the FTC "update the Merger Guidelines to explain more extensively how they evaluate the potential impact of a merger on innovation."[15] So, again, in one breath the AMC said that antitrust as we know it can handle these issues, while in the next breath it said that the Guidelines should be revised.

If there is a lesson that can be generalized, it is that one should approach with considerable skepticism the august pronouncements about the suppleness of antitrust doctrine to accommodate consideration of dynamic

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8 *See id.* at 49 ("We decide this case against a backdrop of significant debate amongst academics and practitioners over the extent to which 'old economy' § 2 monopolization doctrines should apply to firms competing in dynamic technological markets characterized by network effects.").

9 *See* Richard A. Posner, *Antitrust in the New Economy,* 68 ANTITRUST L.J. 925, 925 (2001).

10 *Microsoft*, 253 F.3d at 50 ("As an initial matter, we note that there is no consensus among commentators on the question of whether, and to what extent, current monopolization doctrine should be amended to account for competition in technologically dynamic markets characterized by network effects."); *id.* at 54 ("Whatever middleware's ultimate potential, the District Court found that consumers could not now abandon their operating systems and switch to middleware in response to a sustained price for Windows above the competitive level.").

11 *See id.* at 89-90 ("Applying per se analysis to . . . an amalgamation [of software] creates undue risks of error and of deterring welfare-enhancing innovation.").

12 *See* Microsoft Corp. v. United States, 534 U.S. 952 (2001) (mem.) (denying certiorari).

13 *See* ANTITRUST MODERNIZATION COMM'N, REPORT AND RECOMMENDATION (2007), *available at* http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf.

14 *Id.* at 9.

15 *Id.* at 11.

efficiency. It is time for the antitrust enforcement agencies and the courts to address forthrightly the challenge of developing more dynamically efficient merger guidelines. Achievement of that goal would lay the foundation for an analogous refinement of substantive rules of liability, defenses, and remedies.

## IV. INTELLECTUAL CANDOR AND THE SILENT REVISION OF THE MERGER GUIDELINES

Infusing antitrust analysis with notions of Schumpeterian competition is a good thing. But so is intellectual candor and transparency in the decision-making of those who make and enforce antitrust policy. So, while we applaud the evolution toward an antitrust jurisprudence predicated on dynamic competition, we prefer that the process be more transparent and explicit. A recent merger during the George W. Bush administration illustrates our point.

The XM-Sirius satellite radio merger implicated Schumpeterian competition in several respects, the most significant being whether the relevant product market should be defined strictly in terms of consumer substitution choices. If the market had been defined to consist only of satellite radio, which was being supplied by only two firms, then analysis of the merger would have been trivial. A merger to monopoly would result and drive the Herfindahl-Hirschman Index ("HHI") to its limit of 10,000.

Consequently, the merging parties cast the question as whether consumers considered iPods, streaming audio over wireless Internet, and other kinds of electronic devices to be substitutes for satellite radio.[16] To define the relevant product market, the Horizontal Merger Guidelines evaluate consumer substitution in terms of whether, over a two-year horizon, a 5 percent price increase by a hypothetical monopolist of the product in question would be profitable. This exercise is the evaluation of a small but significant nontransitory increase in price ("SSNIP"). The SSNIP test focuses on consumer substitution. Supply substitution (including entry) is not considered until after market shares are calculated solely on the basis of the static, consumer-oriented market definition. One can dispute whether that approach is good economics; as a matter of law, however, the static approach is the law. The D.C. Circuit in *Microsoft* and the AMC in its report essentially said that the static perspective reflected in the Horizontal Merger Guidelines is adequate to address technologically-dynamic industries, such that a Schumpeterian rewrite of the Guidelines is unnecessary.[17]

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16 XM Satellite Radio Holdings Inc., Proxy Statement (Schedule 14A), at 1-3 (Mar. 5, 2007), *available at* http://www.sec.gov/Archives/edgar/data/1091530/000119312507046506/ddefa14a.htm.

17 *See Microsoft*, 253 F.3d at 49-50; ANTITRUST MODERNIZATION COMM'N, *supra* note 13, at 9.

During the review of the XM-Sirius merger by the Antitrust Division and the Federal Communications Commission ("FCC"), however, it became clear that on multiple issues—relevant market, market power, entry, and merger efficiencies—the enforcement agencies were disinclined to challenge the merger and were, in practice, undertaking a dynamic competition analysis without so characterizing it. Is this dynamic competition gloss bad? It is not bad if one is a Schumpeterian and considers dynamic competition arguments to be valid. But there is a cost to pretending that one is not changing substantive rules when one really is.

The Guidelines have been such a success that the enforcement agencies have, since the 1980s, persuaded the federal courts that this framework is the sensible way to read not only section 7 of the Clayton Act in merger cases, but also sections 1 and 2 of the Sherman Act with respect to market definition, market power, and efficiency defenses. The Guidelines are no longer simply agency statements of prosecutorial discretion. They have been engrafted into the judicial law. In *Whole Foods,* for example, the majority criticized the dissent for having incorrectly applied the Horizontal Merger Guidelines.[18] The success of the FTC and the Division in selling the intellectual superiority of the approach of the Merger Guidelines has painted the agencies into a corner, such that they have less discretion today than twenty years ago. It is harder for the agencies themselves, notwithstanding the fact that they say these Guidelines are not binding, to pretend that they have complete latitude in saying how they will—and the federal courts should—interpret the Guidelines.

We recommend transparency and dialogue. The enforcement agencies should be candid and unambiguous about how they intend to depart from the old, static competition version of the Guidelines. The federal courts should be clearer about whether they believe that authority or reason legitimates the Guidelines.

## V. SYMMETRIC TIME HORIZONS FOR MERGER ANALYSIS

The Supreme Court heard argument in *Pacific Bell Telephone Co. v. linkLine Communications, Inc.*[19] in December 2008. One crucial theme in the case, which has larger relevance to merger analysis, was the tension between consumer welfare and competitor welfare.[20] Many economists refused to sign the amicus brief of antitrust scholars for this case at the end of

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18 *Compare* FTC v. Whole Foods Mkt., Inc., 548 F.3d 1028, 1046 (D.C. Cir. 2008), *with id.* at 1052-57 (Kavanaugh, J., dissenting).

19 129 S. Ct. 1109 (2009).

20 *Id.* at 1109.

2007 on the rationale that the brief was highly critical of the Europeans.[21] Essentially, they said that the brief did not give the more interventionist European perspective its due. Perhaps, like an infant industry argument in international trade, the promotion of competitor welfare in the short term is intended to strengthen competitors in the future such that consumers benefit from price competition or innovation in the future.

One way of restating the concept of short-term compared with long-term welfare is to consider the relevant time horizon for evaluating a number of issues that arise, not only in mergers but also in all big section 1 and section 2 cases. Is a two-year period appropriate for the purpose of defining markets and evaluating market power? Should we evaluate substitution from new entrants over the same period of time? A major inconsistency in merger and antitrust cases concerns the proper time horizon for evaluating the feasibility of proposed remedies.[22] In a merger case, the antitrust enforcement agency may evaluate market power over two years but then seek conditions that extend many more years into the future.

This approach to establishing a time horizon is intellectually inconsistent. It is selectively Schumpeterian. We believe intuitively that symmetry between the length of time used to evaluate market power and the period of time over which we have the ability to fashion sensible remedies ought to exist. However, we think that some kind of guideline of the enforcement agencies should at least squarely address the issue of developing an appropriate time horizon, even if the answer is not our preference that the two time frames be identical.

In broader terms, we recommend that, in addition to revisiting the Horizontal Merger Guidelines, the Antitrust Division and the FTC promulgate guidelines of general applicability for market definition, market power, efficiency defenses, and remedies.

## VI. MERGERS IN TWO-SIDED MARKETS

The Horizontal Merger Guidelines look dated in the more nuanced antitrust matters that routinely arise today. A recurring consideration in many high-tech mergers, for example, is the two-sidedness of markets, as in the case of credit cards.[23] In a two-sided market, two or more sets of consumers exist for the product. The aggregate demand is the vertical summation of

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21 *See* Brief of Amici Curiae Professors & Scholars in Law and Econ. in Support of the Petitioners at 5, 11, 1a-2a, Pac. Bell Tel. Co. v. linkLine Commc'ns, Inc., 129 S. Ct. 1109 (2009) (No. 07-512), 2008 WL 4125499 (listing the economists endorsing the amicus brief who sided with the Pacific Bell Telephone Company as antitrust law diverged between the United States and the European Union).

22 *See, e.g.*, Howard A. Shelanski & J. Gregory Sidak, *Antitrust Divestiture in Network Industries*, 68 U. CHI. L. REV. 1, 4 (2001).

23 *See* William F. Baxter, *Bank Exchange of Transactional Paper: Legal and Economic Perspectives*, 26 J.L. & ECON. 541, 586-87 (1983).

their demand curves. However, the demand curves are not necessarily equidistant from the origin or sloped in the same way. Consequently, in a two-sided market there will be a different demand elasticity and a different willingness to pay for each set of consumers. These characteristics of two-sided markets are central to the network neutrality debate and to antitrust issues in network industries such as telecommunications and financial services.[24]

It is fanciful to suggest, in the spirit of antitrust originalism, that the Merger Guidelines already can address this subtlety. Only recently, and principally in the academic literature, have economists derived a SSNIP test for a multi-sided market.[25] Given the importance of multi-sided markets, the Antitrust Division and the FTC should clarify how they will evaluate market definition and market power in multi-sided markets.

## VII. ANCILLARY REVENUE STREAMS, BANKRUPTCY, AND STATE OWNERSHIP

An issue related to the two-sidedness of markets is the phenomenon of companies "giving away stuff for free"—in essence, Google's business model for search and other web-based services. We call this phenomenon the "ancillary revenue stream problem." In a two-sided market, a company generates revenue from one set of customers and gives away (or subsidizes) products or services demanded by another set of customers. This problem is as old as the newspaper subscriptions and newspaper advertisements in *Albrecht v. Herald Co.*[26]

How does the business model of providing free or subsidized goods dovetail with traditional case law on subjects like predatory pricing? How does a court apply a predation rule in a market where one set of firms sells the product for a positive price while another firm (following a different business model entirely) gives away the same product for free because it derives an ancillary revenue stream elsewhere? Consider the much-scrutinized case of *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*,[27] in which the Supreme Court was particularly troubled that the vertically integrated firm would not sell wholesale access to its ski slopes even when the competitor offered to pay the retail price of a lift ticket.[28] When analyzing a

24 *See* J. Gregory Sidak, *A Consumer-Welfare Approach to Network Neutrality Regulation of the Internet*, 2 J. COMPETITION L. & ECON. 349, 361-62, 468 (2006).

25 *See, e.g.*, David S. Evans & Michael D. Noel, *The Analysis of Mergers that Involve Multisided Platform Businesses*, 4 J. COMPETITION L. & ECON. 663, 675 (2008); Dennis L. Weisman, *Assessing Market Power: The Trade-Off Between Market Concentration and Multi-Market Participation*, 1 J. COMPETITION L. & ECON. 339, 340 (2005) (examining the "trade-off between market concentration and multi-market participation").

26 390 U.S. 145, 147 (1968), *overruled by* State Oil Co. v. Khan, 522 U.S. 3, 7 (1997).

27 472 U.S. 585 (1985).

28 *Id.* at 593-94.

case like this one, where the prevailing business practice seems inexplicable, it is useful to search for an ancillary revenue stream, which may or may not be described in the opinion. If an ancillary revenue stream exists, it might simply explain what otherwise seems to be irrational, non-profit-maximizing behavior.

## VIII. SUBTLER COUNTERFACTUALS IN MERGER ANALYSIS

The antitrust enforcement agencies and the courts should think harder about counterfactuals—not only in the context of the Horizontal Merger Guidelines, but also in antitrust law more generally. To take an example relevant to defining markets under the SSNIP test, it is possible that particular sectors of the U.S. economy will experience deflation. If so, then the counterfactual for a proposed merger may be that prices that would otherwise fall might be stabilized.

This concern over the relevant counterfactual was known to the Antitrust Division and the FCC in the XM-Sirius merger. Prices were not likely to rise after a merger—to the contrary, the merging companies "voluntarily" consented to a temporary price cap.[29] Instead, the more likely competitive effect of the merger would be an increase in the amount of commercial time inserted into the subscription-based programming. Consequently, the proper counterfactual in the XM-Sirius merger was not a price increase, but rather a degradation in product quality while price remained constant. Of course, one could simply recast that competitive effect as a quality-adjusted price increase: after the merger, the candy bar would get smaller, even if the price on the wrapper did not change.

In a revised set of Horizontal Merger Guidelines, it would also be useful to ask about counterfactuals in another way, particularly in the case of financially distressed firms. If the merger were blocked, would an alternative transaction (or set of transactions) be likely that would have a lesser risk of reducing competition? In the case of XM and Sirius, for example, was it plausible for another company to acquire one of the merging firms? If so, could two alternative acquisitions have occurred, such that each of the satellite radio companies could have merged with a firm other than its direct competitor?

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[29] *See* Farrell Malone & J. Gregory Sidak, *Should Antitrust Consent Decrees Regulate Post-Merger Pricing?*, 3 J. COMPETITION L. & ECON. 471, 471-72 (2007); J. Gregory Sidak & Hal J. Singer, *Evaluating Market Power with Two-Sided Demand and Preemptive Offers to Dissipate Monopoly Rent: Lessons for High-Technology Industries from the Antitrust Division's Approval of the XM-Sirius Satellite Radio Merger,* 4 J. COMPETITION L. & ECON. 697, 702-03 (2008).

## CONCLUSION

For all the reasons we have discussed above, the antitrust enforcement agencies should revise the Horizontal Merger Guidelines to take dynamic competition concerns explicitly into account. We conclude by adding one cautionary tale. If the antitrust enforcement agencies do not exercise leadership by revising the Horizontal Merger Guidelines, the counterfactual is not necessarily the status quo. It is more likely that sector-specific regulatory agencies will fiddle with merger policy in pursuit of goals unrelated to consumer welfare maximization.

The U.S. economy will likely be more regulated under President Obama than under former president George W. Bush. The federal government will play a greater role in ownership and control of business enterprises. Regulatory agencies are more likely to acquire than shed powers. To take one regulatory agency, consider how the FCC has conducted merger analysis in comparison with how the Antitrust Division and FTC conduct it. We foresee a risk of sector-specific regulatory bodies performing considerable amounts of bad antitrust analysis. In the XM-Sirius satellite radio case, the FCC came to the same conclusion as the Antitrust Division that the merger should be allowed. But the FCC did so by reasoning that contradicted the Antitrust Division's analysis of market definition.[30] To justify continuation of the structural regulation of terrestrial broadcasting, the FCC needed to explain why the merger was not unlawful *without* saying that terrestrial radio, iPods, and streaming audio over wireless Internet are all in the same product market as satellite radio. The FCC, in essence, said that the Antitrust Division reached the correct answer through faulty reason.

Multiply that incident by the number of sector-specific approvals that will be required as the many newly nationalized companies in the United States restructure themselves through mergers or acquisitions. It is unlikely that a coherent merger policy that recognizes the role of dynamic competition will emerge if the Antitrust Division and the FTC fail to act.

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30 *Compare* Sidak & Singer, *supra* note 29, at 700 (stating that the Division did not challenge the merger because the evidence did not show the parties would be able to profitably increase prices after the merger), *with id.* at 701 (arguing that the FCC did not challenge the merger because the parties allowed rent extraction and created a new price-regulated monopoly).