Department of Justice

FOR IMMEDIATE RELEASE
MONDAY, JUNE 14, 1982

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Attached are copies of Attorney General William French Smith's statement announcing the new antitrust merger guidelines, the press release describing them, and the merger guidelines.

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STATEMENT BY ATTORNEY GENERAL WILLIAM FRENCH SMITH
RELEASING THE NEW DEPARTMENT OF JUSTICE MERGER GUIDELINES

Today I am pleased to announce the fulfillment of one of my major policy objectives as Attorney General -- the release of new Department of Justice Merger Guidelines. These Guidelines replace an earlier set issued in 1968.

This Administration is committed to a strong antitrust policy that will safeguard competition in our free enterprise economy. The American public is ill served, however, when unnecessary uncertainty about government enforcement standards inhibits otherwise lawful and procompetitive commercial transactions. Our new Merger Guidelines should reduce much of that uncertainty by delineating the general principles and specific standards used by the Antitrust Division in screening the hundreds of mergers that must be examined each year.

These Guidelines are the product of over a year of concentrated effort by a number of lawyers and economists within the Antitrust Division. In addition, we have benefited from comments by the staff of the Federal Trade Commission, and we thank them for their part in this effort. The Guidelines have already been transmitted to the members of the FTC, the Senate and House Judiciary Committees, and the Senate Small Business Committee.

The new Guidelines do not represent new policy for this Administration. They are instead a formal embodiment of the existing policy of aggressively prosecuting anticompetitive mergers. Some mergers pose serious competitive problems, but most do not. The purpose of the Guidelines is to tell the public how the Antitrust Division draws that line.

While the 1968 Guidelines expressly contemplated future revision, no formal changes were made during the intervening 14 years. During that time, however, new economic thinking and new judicial attitudes and decisions have rendered the 1968 Guidelines largely obsolete in important respects. Although comparison between the old and the new Guidelines is inevitable, the more important comparison is to the actual practice of the Department over recent years. Viewed in this light, the new Guidelines constitute an evolutionary change -- not a revolutionary change.

The process of writing the Guidelines has itself been useful to the Department in clarifying its own thinking about mergers. Constant interaction has occurred between the Guideline rewriting project and the staff analysis of actual merger cases. The Guidelines make eminent economic sense, but they also serve the important function of informing the public how the Antitrust Division analyzes specific merger situations.

As pleased as we are with this new statement on merger policy, the Guidelines should not be taken for more than they can be. A constant tension exists between the desire to include every relevant economic factor and the need to provide clear guidance to the business community. The Guidelines could therefore never fully cover every circumstance in which the Department would or would not challenge a merger. Nevertheless, their relative clarity, broad scope and economic reasonableness convince me that they will make an important and enduring contribution to this area of the law.

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Attorney General William French Smith today announced guidelines which outline the standards now in use by the Department of Justice in determining what mergers it will challenge.

The new guidelines replace those issued by the Department in 1968. In 44 pages they outline the general principles and specific standards the Department's Antitrust Division uses in screening the hundreds of mergers it examines every year.

The Attorney General emphasized that the guidelines are not a comprehensive statement of the circumstances considered by the Department in determining whether to challenge a merger. Their purpose is to provide guidance to the business community, private lawyers and others in anticipating what standards will be used and how they will be applied. For that reason, he noted, they give as much attention to situations in which a challenge is unlikely as to those in which a challenge is likely.

Usually a challenge comes in the form of a civil suit by the Antitrust Division charging a violation of Section 7 of the Clayton Act or Section 1 of the Sherman Act -- both of which prohibit anticompetitive mergers. Such a suit often seeks divestiture of the acquired firm or one or more units of either firm in order to remove the anticompetitive problem. Such suits are frequently settled by consent decree. The Department generally requires prior elimination of the competitive problem before entering into such court-enforced settlements. Sometimes proposed mergers are abandoned after the Department threatens suit.

The 1968 Guidelines

Though it was made clear when the 1968 guidelines were issued that they would be revised as time went by, no formal changes were ever published. The standards employed in analyzing mergers have changed substantially since that time, however. For that reason, the new guidelines differ considerably from the old ones, although the new guidelines simply reflect the standards and policy now in use.

The 1968 guidelines dealt with three kinds of mergers -- horizontal, vertical and conglomerate. Horizontal mergers are those between competitors, such as two auto makers. Vertical mergers are those involving firms in the same supply chain, such as a manufacturer of a product and the distributor of the same product. Conglomerate mergers are those between firms in different lines of business or between firms in the same line of business in economically separate geographic regions.

The 1968 guidelines set forth standards for each of the three kinds of mergers. The new guidelines have only two categories -- horizontal and non-horizontal mergers.

The New Guidelines

The main purpose of the Department's merger enforcement is the prevention of mergers that make easier the exercise of market power -- the ability of one or more firms to raise prices above a competitive level. All the standards mentioned in the guidelines involve factors bearing on that ability. The purpose of the guidelines is to prevent the monopolization or cartelization -- control by one or by several firms -- of any significant economic markets.

In general the new guidelines may allow some horizontal mergers that the old guidelines would have challenged, and generally provide for the challenge of other mergers only where there are indications that there would be some horizontal effect, real or potential. In other words, they usually require an indication of harm to competition by affecting firms in competition with one another. Those changes reflect the gradual trends in judicial merger decisions and Department of Justice enforcement practices between 1968 and the beginning of the 1980's. In addition, the new guidelines reflect some changes in emphasis which began with this Administration in early 1981.

The purpose of the new guidelines is to reflect the current emphasis -- both in the Antitrust Division and in the courts -- on the need for economic evidence of harm or potential harm to competition before a merger will be challenged. The new guidelines were designed to quantify the standards applied to the extent that is practicable. Where numbers are not applicable, efforts were made to state in detail the kinds of factors that would be weighed.

In analyzing any merger, it is first necessary to determine the relevant market or markets in which competitive harm may occur as a result of the merger. For instance, two merging grocery chains may be operating nationally with direct competition in dozens of major cities. To remove the competitive problems of a merger it could be necessary for them to spin off to third parties one of the stores in each of those cities, so that the merger would no longer reduce competition. If, on the other hand, they were only in competition in two cities in the Midwest, the sale of one outlet in each of those two cities might solve the problem.

In determining whether or not the risk of harm to competition is enough to warrant a challenge by the Antitrust

Division, one of the most important factors is the level of concentration in that particular market, whether it be a national market for a particular drug or a local market for freshly baked doughnuts.

The Herfindahl Index

One significant change from the 1968 guidelines is the use of a different index to measure market concentration.

The 1968 guidelines used the four-firm concentration ratio to measure market shares. The four-firm concentration ratio is the sum of the percentage market shares of the top four firms in the market.

The new guidelines use the Herfindahl index instead. That index is calculated by squaring the percentage market share of each firm in the market and then adding those squares.

The Herfindahl index was chosen because it gives a more accurate measure of market structure than the four-firm concentration ratio. For instance, if there were a market in which four firms each had a 15 percent share and 40 firms each had a one percent share, and a second market where one firm had 57 percent of the market and the remaining 43 firms one percent each, the four-firm concentration ratios would be identical -- 60 percent each.

The Herfindahls for those two markets would be far from the same, however. The first market would have an index of 940 and the second an index of 3,292 -- more than three times as great. In the first market, the Department's concern about mergers would be relatively low, and in the second, quite high. In actually applying the Herfindahl index to a merger situation two figures are important -- the index of concentration after the merger, and how much that differs from the index before the merger.

Market Definition

A second significant change from the 1968 guidelines is the fact that the new guidelines discuss the process of market definition in considerable detail. Defining the relevant market is one of the most important steps in merger analysis, because what market is selected and how that market is defined can be vital in determining whether or not the merger is deemed anticompetitive enough to warrant challenge by the Antitrust Division.

Since the relevant market chosen for analysis is the foundation on which all later analysis depends, the principles applied in market definition should be consistent. Although market definition will always depend on the specific facts in each case, the guidelines describe general principles that will be applied consistently in this process, which will still involve a fair amount of judgment and discretion on the part of those making the analysis.

Throughout the section of the guidelines dealing with market definition is an emphasis on defining a market in terms of the underlying concern about market power that is the basis for the guidelines themselves. The goal of market definition is to identify and consider all the firms that would have to cooperate in order to raise prices above the competitive level and keep them there.

For instance, the guidelines suggest that in considering whether to include a particular product or firm in the market it may be useful to hypothesize a small price increase, and then consider whether such an action would be likely to cause customers to shift to a different supplier or a different product. If a sufficient number of customers would shift to a substitute product or another supplier to make a price increase unprofitable, the market probably needs to be expanded to include that product or that supplier.

Once the market is defined, the guidelines provide standards for analyzing the merger. The standards applied depend on whether the merger is horizontal -- in which the merging firms are in the same market -- or non-horizontal -- which includes all other mergers.

Since the bulk of mergers that pose competitive problems are horizontal ones, the guidelines focus primarily on them.

Horizontal Mergers

The standards applied to horizontal mergers fall into three general areas. They are the level of concentration in the market after the merger, the ease of entry by other firms into the market, and a series of factors bearing on the ease or profitability of collusion.

Market concentration is important because it is much easier to raise prices above a competitive level and keep them there in a highly concentrated market.

Ease of entry is important because if enough firms can enter by constructing new facilities or converting existing ones, an effort to increase price would not be profitable because other firms could be drawn in and drive prices down.

Ease and profitability of collusion are important because there is less likelihood that firms will try to get together to raise prices above a competitive level when it is difficult or unprofitable.

What Mergers Will Be Challenged

In analyzing market concentration in a horizontal merger the guidelines use the post-merger Herfindahl index to set forth three levels of concentration:

-- where the post merger market is "unconcentrated," that is, where even after the merger the Herfindahl is below 1,000. In such an "unconcentrated" market the Department would be unlikely to challenge any merger. An index of 1,000 indicates the level of concentration that exists, for instance, in a market shared equally by 10 firms.

-- where the post-merger market is "moderately concentrated," with an index between 1,000 and 1,800, a challenge would still be unlikely, provided the merger increases the index by less than 100 points. If the merger increases the index by more than 100 points, a challenge by the Antitrust Division would be more likely than not, with the decision being based on the extent of the increase, the ease of entry, and the presence or absence of other relevant factors specified in the guidelines.

-- where the post-merger market is "highly concentrated," resulting in an index above 1,800, challenge is unlikely where the merger produces an increase of less than 50 points. If the merger produces an increase in the index between 50 and 100 points, challenge is more likely than not, again depending on the size of the increase, ease of entry and other factors as specified. If the merger produces an increase in the index of more than 100 points, challenge is likely. An index of 1800 indicates the level of concentration that exists, for instance, in a market shared equally by approximately six firms (5.56 equally-sized firms, to be precise).

In addition, if the leading firm in the market has a market share of 35 percent or more and is about twice as large as the second largest firm or larger, the Department is likely to challenge a merger by the largest firm with any firm having at least one percent of the market. In such a case, the only possible mitigating factor to be considered by the Department would be easy of entry.

A shorthand way to calculate the increase in the Herfindahl index that would be created by any merger is to multiply the percentage shares of the two merging firms and then double the product. For instance, the merger of a 25 percent firm with a two percent firm would give an increase of 100 points (25 x 2 x 2), and the merger of two firms with seven percent each would yield an increase of 98 points (7 x 7 x 2).

Converted into the Herfindahl measurement, the 1968 guidelines stated that a challenge was likely for mergers that increased concentration by 30-40 points in highly concentrated markets (four-firm concentration of 75% or more) and by 50-90 points in less highly concentrated markets (four-firm concentration of less than 75%).

Unlike the new guidelines, however, the old guidelines did not state that mergers producing smaller increases in concentration would not be challenged. Similarly, the old guidelines did not recognize an unconcentrated region where challenges were generally unlikely.

New Entry

The inferences drawn from the concentration numbers above may be adjusted to take account of very easy entry to the market. The reason that ease of entry is so important is that where firms not already in the market can enter it very easily, inferences drawn from the post-merger concentration index can be misleading. Because ease of entry cannot be expressed in market statistics, it has to be looked at as an independent consideration but one which the guidelines make clear is very significant.

Other Factors

Compared to the old guidelines, the new guidelines identify a much larger number of additional factors that the Department will consider in deciding whether to challenge a merger.

The other factors to be considered are ones which might justify some adjustment in the inferences to be drawn from the post-merger concentration. The guidelines state that, where relevant, these factors will be used to resolve close cases.

These factors generally deal with the ease and profitability of collusion among sellers to raise prices above competitive levels. They fall into four rough categories, dealing with:

-- the nature of the product and the terms of sale;

-- availability to firms in the market of information about specific transactions and buyer market characteristics;

-- conduct of firms in the market;

-- market performance.

Within each category, the relevance of the factors to the likelihood of collusion is explained. For instance, with homogeneous products, the number of issues on which competitors must agree in order to raise prices is smaller, thus making effective collusion more likely.

Factors that may make a challenge more likely include:

-- extreme homogeneity of product;

-- substantial gaps between the products in the market and the next best substitute;

-- particularly strong similarities in the products of the merging firms compared to the products of other firms in the market;

-- readily accessible information about specific transactions in the market;

-- a market for the product in which buyers' orders are frequent, regular and small compared to the total output of the typical firm in the market;

-- evidence of prior horizontal collusion among firms in the market;

-- use by substantially all the firms in the market of mandatory delivered pricing, or exchange of sensitive price or output information, or collective standardization of characteristics of the product which were at one time the basis for competition, or price protection clauses, or the fact that the acquired firm has been an unusually competitive force in the market, or the fact that before the merger the market appears to be operating in a non-competitive way.

The only factor discussed in the horizontal section that would make a challenge less likely is extreme heterogeneity of the relevant product. A footnote, however, points out that a similar situation may exist where there is rapid technological change or where supply arrangements consist of many complicated terms in addition to price. Those three factors make successful collusion more difficult.

Non-horizontal Mergers

The guidelines make clear that although non-horizontal mergers are less likely to harm competition, they are not always innocuous. They make plain that much of what is said about horizontal mergers could also be applied to non-horizontal mergers -- such as the discussion of market concentration, ease of entry and other factors -- and they discuss five non-horizontal theories of liability.

The five non-horizontal theories of liability under which such mergers might be challenged are:

-- the elimination of specific potential entrants into the market;

-- the creation of barriers to entry to the market through vertical mergers;

-- the facilitation of collusion through vertical mergers which integrate the firms to include the retail level;

-- the elimination through vertical merger of a disruptive buyer;

-- the evasion of rate regulation.

For each of the five theories the guidelines describe the possible harm and the conditions necessary for that harm to occur.

Defenses

In a concluding section dealing with defenses to an antitrust challenge to a merger, the guidelines indicate that only in extraordinary cases will the Department consider a claim of efficiencies as a mitigating factor to a merger that would otherwise be challenged. They also indicate that a stringent analysis will be applied to the so-called "failing firm" defense, a doctrine which may immunize otherwise anticompetitive mergers. Before recognizing the defense, the Department will require that the failure of the firm is very likely and that no less anticompetitive acquisition be available.

Conclusion

The guidelines do not oblige the Department or the Antitrust Division to consider or ignore any factors in analyzing mergers. That consideration will still, as in the past, require the exercise of judgment and discretion. The purpose of the guidelines is to reduce uncertainty to the reasonable minimum consistent with an uncertain and evolving area. For those seeking more certainty as to the Department's enforcement intent, specific proposed conduct may be described to the Department as part of the Business Review Letter procedure, and a letter dealing with the enforcement intent of the Department, where appropriate, will be sent in return.

The guidelines represent more than a year of work by the economists and lawyers of the Antitrust Division, and were prepared at the direction of, and with the active involvement of, William F. Baxter, Assistant Attorney General in charge of the Antitrust Division.

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