UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA,

Plaintiff,

v.

H&R BLOCK, INC.;
2SS HOLDINGS, INC.; and
TA IX L.P.,

Defendants.

Civil Action No. 11-00948 (BAH)
Judge Beryl A. Howell

REDACTED VERSION
FOR PUBLIC FILING

DECLARATION OF FREDERICK R. WARREN-BOULTON
SUMMARIZING EXPECTED DIRECT TESTIMONY

INTRODUCTION

1. I have been a practicing economist for more than 40 years and much of my professional experience has involved the analysis of proposed mergers and the study of the appropriate methods for such analysis. I previously served as the DOJ Antitrust Division's chief economist and in that capacity I supervised approximately 40 economists in the review of numerous mergers and other competition issues.

2. I was retained by the Antitrust Division to provide my opinion concerning the likely competitive effects of the transaction at issue in this case. I have concluded that the relevant market to analyze this transaction is the market for digital do-it yourself tax preparation products (digital DIY) and that the transaction is likely to result in significant harm to consumers arising from higher prices and reduced non-price competition. My conclusions are based on work that I did, or that was undertaken at my direction, including: (a) a review of documents and testimony conclusively indicating that the parties view each other as direct competitors and undertake significant competitive responses to each other's actions; (b) an analysis of data regarding

pricing and switching (including data produced by the parties and the IRS) to determine diversion ratios; (c) the application of the hypothetical monopolist test to define the relevant market; and (d) the use of a merger simulation model to predict the unilateral price increases expected from the merger. These are standard methods applied by economists in merger analysis.

3. I have also considered the report and opinions of the Defendants' expert, Dr. Christine Meyer, and concluded that nothing in her report or opinions provides a basis to revise my own opinions. To the contrary, Dr Meyer's critical conclusions appear to rest largely not on the application of standard economic models or analysis, but on the misuse or misunderstanding of surveys and other work conducted by the parties that itself appears to be flawed.

4. My analysis is confirmatory of what common sense tells us about this transaction. Using digital DIY products to do your taxes is very different than using pen-and-paper or paying someone else to do your return. That is why a robust market for digital DIY products has emerged. That market is now dominated by three competitors, Intuit, H&R Block (HRB) and Second Story Software (2SS), who collectively have a nearly 90% share. For many years, 2SS has been a maverick competitor, pricing substantially below HRB and Intuit and introducing innovations such as "free" products that have forced competitive responses from HRB and Intuit. One such significant 2SS innovation allows all taxpayers to prepare and e-file their federal tax returns for free. 2SS does this with the expectation that many consumers will purchase add-on features, such as a corresponding state tax return, and some will, in successive years, switch to a "paid" TaxACT product.

5. H&R Block, which makes HRB at Home, and Intuit, which makes TurboTax, were forced to respond to 2SS's business model by redesigning their product lineups to include their own free federal tax return products, though with fewer tax forms than TaxACT. HRB and Intuit seek to

generate revenue from customers who start with their free products by selling similar add-ons and converting customers to paid products. However, for HRB and Intuit, these free federal products "cannibalize" their paid products to a much greater degree than for 2SS. In other words, a significant number of customers who would have purchased HRB and Intuit paid products have moved to free federal products and only upgrade as needed. Moreover, new customers coming into the market who would have selected paid products also often start (and sometimes finish) their returns with free products. 2SS does not have significant cannibalization concerns because, among other reasons, while its menu of products offers similar functionality to HRB's and Intuit's, 2SS earns a smaller dollar margin on its highest priced products.

6. Since 2SS made its "Free-For-All" offer to all taxpayers, free federal tax preparation has become the most popular product in the digital DIY market. At the same time, the average inflation-adjusted price paid by digital DIY customers has declined 10%.

7. Defendants argue that, because the "free" marketing message is an important customer acquisition tool, they have little or no incentive post-merger to eliminate free federal products or otherwise raise prices or reduce quality. The question, however, is not whether HRB or Intuit will stop offering and marketing a "free" product (i.e., free federal), but how the merger will alter the marketing and pricing of 2SS and HRB's products including other components of the bundle purchased by customers who buy the "free" (federal) product. After the acquisition, HRB will have an incentive to charge higher prices for products across their product lineup, and, HRB will have an incentive to shift customers to its higher priced paid products by reducing the value proposition provided by 2SS.

8. There is a substantial likelihood of consumer harm when a merger eliminates a maverick competitor, leaving the market in the hands of an effective duopoly of competitors who had been charging higher prices than the maverick.

RELEVANT PRODUCT MARKET

9. The relevant product market for this case is digital DIY tax preparation products, which includes products from HRB, Intuit, and 2SS, as well as products from several fringe firms. The hypothetical monopolist test set out in the Horizontal Merger Guidelines, and widely used by economists, substantiates this market definition. In my opinion, a monopolist of digital DIY tax preparation products would increase prices significantly, notwitstanding switching by some customers to other forms of tax preparation. Under the test, the hypothetical monopolist need not control every substitute product, only enough of them that it would profitably impose a significant increase in price on at least one product sold by one of the defendants.

10. In brief, my conclusion as to market definition is supported by substantial evidence showing that:

10.1. Defendants viewed each other as significant competitors.

10.2. Intuit and HRB have reacted to competitive initiatives by 2SS.

10.3. Consumers perceive TaxACT as similar to [redacted] HRB. [redacted] My analysis reveals that on key consumer drivers identified by HRB, consumers seem to view TaxACT and HRB as close competitors.

10.4. Neither pen-and-paper nor assisted would prevent a hypothetical monopolist of digital DIY from raising price substantially, a conclusion supported by testimony to this effect by former and current executives of HRB, Mark Ernst, former Chairman and CEO of HRB, and HRB's Jason Houseworth.

10.5. Defendants market to the same customers, as, Jason Houseworth, HRB's Head of Digital Tax Solutions, admitted as much in his deposition. Targeted marketing efforts by 2SS have impacted the sales of HRB and Intuit.

10.6. While defendants point to a survey conducted for litigation and to a price simulator to indicate a broader relevant market, the survey and price simulator contradict their documents and the testimony of their executives, and I find neither credible. Professor Ravi Dhar has evaluated the April 2011 survey and concluded it was "severely flawed" and "fails to meet the basic premises of good survey design." I find his reasoning persuasive. The price simulator produces an estimate of diversion from HRB products to TaxACT, other digital DIY products and other methods of tax preparation, but the pricing simulator results show significant violations of basic principles of economic theory. Even if this price simulator_were found reliable, and I do not believe it is, the pricing simulator output relied on by Dr. Meyer cannot be used to inform the diversion ratio most important to this case: the diversion from TaxACT to HRB products. With respect to the diversion ratio from HRB to TaxACT, Dr. Meyer's analysis relies entirely on a single comparison of two groups of pricing scenarios, but I find that comparisons using alternative scenarios give wildly different results. Defendants' documents also contain other surveys that suggest substantially different results.

HARM TO COMPETITION

11. The proposed acquisition will combine the second and third largest digital DIY firms, resulting in two firms together controlling 90% of the market.

12. After analyzing both the potential unilateral and coordinated effects, I have concluded that the proposed acquisition likely will cause anticompetitive harm. Unilateral effects occur as a result of the combined firm acting without cooperation from its competitors; coordinated effects occur as a result of the combined firm coordinating its actions with rivals, here, Intuit. Coordinated effects do not require explicit or even implicit agreement among firms. Dr. Meyer argues that unilateral and coordinated effects would be inconsistent with HRB's claimed strategy to continue to offer TaxACT as a free product. I do not predict that this merger will necessarily cause the merged firm to cease offering free products. I conclude that this merger gives HRB the incentive and the ability to compete less aggressively than TaxACT would have with respect to price or quality.

COMPETITIVE HARM FROM UNILATERAL EFFECTS

13. The likelihood and magnitude of unilateral price effects depends to a large extent on the degree of direct competition between defendants. When considering a price increase, defendants take into account what they would lose to their competitors as a result and compare it to what they would gain from those customers who will pay the higher price. Today, the loss for each defendant would include business the other would capture. If the proposed acquisition takes place, this would change. A price increase on a 2SS product would lead some customers to use an HRB product, and HRB would expect to generate significant incremental profit per such customer, especially since the merged firm will earn more per customer on the HRB product than on the 2SS product.

14. A valuable measure of the degree of direct competition between firms is the diversion ratio, which measures the portion of lost customers that would go to a specific firm as a result of a price increase. Substantial evidence supports the proposition that significant diversion exists

between the defendants. Documents show that defendants consider each other competitors: they track each other's market share, prices, advertising, web traffic, and product quality; and they respond to each other in ways that benefit consumers. Empirical evidence also shows that defendants take business from each other by competing harder, (e.g., through increased marketing). Documents demonstrate that defendants consider one another's pricing when they make pricing moves.

15. Merger simulations are a well-accepted tool for putting some structure on this analysis. They provide a way to examine the interaction of diversion ratios, margins, price, and quantities. The merger simulations I have run indicate that in the absence of efficiencies TaxACT prices would increase between 8-15% while HRB prices would increase between 2-4%, and cause harm to consumers in the many millions of dollars annually.

16. Dr. Meyer's criticisms of the merger simulations that I have run are not compelling for the following reasons:

16.1. By their nature, economic models make simplifying assumptions. The question is not whether the model captures every detail of the real world, but whether it reflects the essence of competition. Dr. Meyer correctly identifies ways in which my merger simulation is simpler than the real world but fails to demonstrate that the simplifying assumptions undermine the validity of the results.

16.2. Switching data reflect who filed in one year using one method and then switched the next year to another method. Switching rates and diversion rates measure different things (the former measures switching regardless of cause, while the latter seeks to measure it as a result of a price increase), but that does not mean that the former cannot serve as a proxy for the latter. In this case, evidence that switching to assisted tax preparation overstates diversion indicates that any bias in the merger simulation when run using switching rates as a proxy for diversion rates may favor defendants. [redacted] HRB [redacted] documents imply that more than half of switching from digital DIY to assisted preparation occurs for reasons unrelated to price, such as a change in tax complexity. Data provided by the IRS suggests that taxpayers that switched from a digital DIY product to assisted preparation are about twice as likely to have an observable increase in tax complexity as taxpayers that stayed within the digital DIY market.

16.3. Moreover, I did not derive my estimated diversion ratios only from switching rates. I derived similar diversion ratios based on a methodology that HRB has used in the course of its business to analyze the effects of customer switching, which relied on market share as the basis for diversion within the digital DIY market. Diversion proportional to market share assumes that market shares, which reflect consumers' first choices, also reflect consumers' second choices. Finally, diversion rates much lower than those estimated from market shares and IRS data would be inconsistent with the wealth of documentary evidence that illustrates that HRB and 2SS view each other as significant competitors.

COMPETITIVE HARM FROM COORDINATED EFFECTS

17. The evidence shows that HRB and Intuit share similar incentives to structure their product lineups and prices in a way that preserves the profitability of their high priced products. 2SS's incentives are different, as made clear from their disruptive conduct over the years, because they do not share HRB's and Intuit's concern about cannibalizing higher priced products. 2SS's different incentives make it the market "maverick" and have forced HRB and Intuit to restructure their digital DIY product lineups in a way that makes it more difficult for them to sell their higher margin products. As the Merger Guidelines explain, "An acquisition eliminating a

maverick firm in a market vulnerable to coordinated conduct is likely to cause adverse coordinated effects."

18. This merger would eliminate this stark contrast in incentives among 2SS, HRB, and Intuit, thus increasing the likelihood that HRB and Intuit could reach a common understanding about the best way to structure their product lineups to better "up-sell" customers. Customers would lose the competition-enhancing benefits that come from having such an effective maverick in this market.

ENTRY, EXPANSION, AND REPOSITIONING

19. Obstacles faced by new entrants and small rivals make it unlikely that they would deter or counteract a unilateral or coordinated anticompetitive effect. Trust and reputation are important drivers for consumer demand in this industry, and customers need convincing before large numbers can be expected to rely on a product – no matter how much excess production capacity a vendor possesses. While Dr. Meyer points to the FFA as a way to enter and expand, she fails to point out that the FFA's role as a sales channel has decreased substantially over the past several years.

EFFICIENCIES

20. Defendants' claimed efficiencies do not appear, by and large, to be verifiable or merger-specific, for reasons set forth in the expert report of Dr. Mark Zmijewski. Two additional points merit mention here: The claimed fixed cost savings from efficiencies do not appear to fit within any accepted theory under which fixed cost savings would counter the threat of anticompetive harm from an acquisition. Second, even if I accepted all variable efficiencies that Dr. Meyer credits, which I do not, I would still find significant unilateral harm likely. Incorporating her

efficiencies into the merger simulation still results in likely harm to consumers of millions of dollars annually.

Frederick R. Warren-Boulton

September 1, 2011