C34 Lecture 3

Mergers (Horizontal and Conglomerate)
Section 7 of the Clayton Act (as amended by Cellar-Kefauver Act)

- Prohibited mergers where the effect was to “substantially lessen competition”
- Remedied a defect of the Sherman Act
  - SA could only attach mergers bordering on monopoly
- Economic issues:
  - What incentives do firms have to merge?
  - What is the effect on economic efficiency?
- Legal/practical issue: Market Definition
- Legal precedents: G can block any merger
- Need to establish MERGER GUIDELINES
Why do firms seek to merge?

• Cost Efficiencies
  – Eliminate redundant activities
  – Reduce overhead costs
  – More fully exploit economies of scale and scope
  – Reduce transportation costs
  – Reduce advertising costs

• Higher prices
  – SCP theory: Mergers increase concentration, leading to higher prices
  – Oligopoly models: Fewer firms lead to higher equilibrium prices
  – But, benefits of higher prices accrue to all firms, not just merging firms
Horizontal mergers: the economic efficiency tradeoffs

- 4 surplus areas to consider:
  - A: efficiency gains
  - B: consumers’ surplus loss
  - C: producers’ surplus loss due to reduced volume
  - D: transfer from consumers to producers

- Change in total surplus equals: $A-(B+C)$
- What if market is initially competitive?
Key legal and practical issue: market definition

• Implementing the Clayton Act criteria:
  “. . . substantially lesson competition in any line of commerce or section of the country.”
• Requires market definition
  – What is the relevant “line of commerce” (product market)?
  – What is the relevant “section of the country” (geographic market)?
• Importance of market definition:
  – Broad d-o-m makes it difficult to argue that competition will be lessened as a result of the merger
  – Narrow d-o-m makes it easier to argue that competition is affected
• Market Definition is the primary activity of economic consultants working in antitrust
Brown Shoe (1954)

- First case after Cellar-Kefauver Act closed asset acquisition loophole
- Established importance of market definition based on the principle of “reasonable interchangeability”
  - “The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it.”
- Established doctrine of incipiency
  - “If a merger achieving 5 percent control were now approved, we might be required to approve future merger efforts by Brown’s competitors.”
- SC demonstrated willingness to forego efficiencies
  - “But we cannot fail to recognize Congress’ desire to promote competition through the protection of viable, small, locally owned businesses.”
ALCOA et. al. (1964), Continental Can Co. et. al. and Von’s (1966)

- Court used a narrow d-o-m (aluminum cable only) to block ALCOA’s acquisition of Rome
  - ALCOA: large share of aluminum cable
  - Rome: copper cable, small amount of aluminum
- Court used a broad d-o-m (containers) to block Continental Can’s acquisition of Hazel Glass
  - Con Can: cans
  - HG: bottles
- In Von’s, the Court blocked a merger to 7.5% in the competitive LA grocery market
  - Again citing Congressional intent to preserve small firms
Government “Invincibility” and the need for Merger Guidelines

- By the late 1960s, it had become clear that G could block most mergers it opposed
- Latest DOJ Merger Guidelines noteworthy for
  - Use of the *Herfindal-Hirschman Index* (HHI) to measure industry concentration
  - Proposing a specific test for market definition
- Established “safe harbor” for proposed mergers in terms of
  - Post-merger concentration levels
  - Change in concentration caused by the merger
Herfindal-Hirschman Index (HHI): “scientific” measure of industry concentration

- Consider a market with n firms, ordered with respect to size
- $\text{HHI} = (\text{share } 1)^2 + (\text{share } 2)^2 + \ldots + (\text{share } n)^2$
- Examples (using ten firm industries):
  - Equally sized firms: $\text{HHI} = 10(10)^2 = 1000$
  - 1 with 55%, 9 with 5%: $\text{HHI} = 3025 + 9(25) = 3250$
  - 4 with 15%, 4 with 10%, 2 with 5%: $\text{HHI} = 4(225) + 4(100) + 2(25) = 1300$
- Changes in the HHI calculated on the basis of pre-merger market shares. E.g., suppose firms $i$ and $j$ (with shares $s_i$ and $s_j$) merge to form firm $m$ with share $s_m$
  
  $\text{HHI}^{\text{post}} = \text{Sum} + (s_m)^2 = \text{Sum} + (s_i + s_j)^2$
  
  $\text{HHI}^{\text{pre}} = \text{Sum} + (s_i)^2 + (s_j)^2$
  
  $\Delta \text{HHI} = \text{HHI}^{\text{post}} - \text{HHI}^{\text{pre}} = 2s_is_j$
Application of HHI measures

• DOJ Categories
  – Highly Concentrated: HHI > 1800
  – Moderately Concentrated: 1000 ≤ HHI ≤ 1800
  – Unconcentrated: HHI ≤ 1000
• “Safe harbors” for mergers (see VVH, page 214)
  – ΔHHI ≤ 50
  – ΔHHI ≤ 100 and HHI ≤ 1800 (markets not highly concentrated)
  – Unconcentrated markets HHI ≤ 1000
• Proposed “unsafe” mergers subject to further scrutiny based on
  – Entry conditions
  – Efficiency considerations
Market Definition under the Merger Guidelines

- What is the denominator in the HHI calculations?
- DOJ “thought experiment:”
  - Given a market definition, would a hypothetical monopolist of that market find it profitable to increase prices by 5%?
  - If not, expand the market definition
  - “Relevant antitrust market” is the smallest set of products and geographic areas that satisfies this test
- Geographic markets can then be defined in terms of transportation costs
- Product market definition more abstract
- Question: What if price is already at the monopoly level?
Conglomerate Mergers involving non competing firms (e.g., SBC - Ameritech)

- Why would G want to stop?
  - If firms want to do it, must be efficiency reasons
- Potential Competition rationale
  - Merger may eliminate the most likely entrant into the industry
- *FTC v. Procter & Gamble et. al. (1967)*
  - P&G did not sell bleach and wanted to acquire Clorox
  - Court accepted FTC potential competition argument
    - “Procter had considered the possibility of independently entering but decided against it because the acquisition of Clorox would enable Procter to capture a more commanding share of the market.”
- DOJ criteria for challenging a Conglomerate Merger
  - Must be a highly concentrated market (HHI ≥ 1800)
  - Entry must be difficult
  - Eliminated potential competitor must be one of “top 3” prospects
  - Acquired firm’s share must be at least 5%