Market Power and Antitrust Policy

– Enforcement and Emerging Issues –

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Overview

- Market Power
- Antitrust Enforcement
- Emerging issues and debates

Market Power

definition and theoretical considerations

Perfect Competition

- The perfectly competitive market outcome:
  - Results in zero (economic) profit (marginal cost pricing)
  - Maximizes consumer welfare
  - Leaves no possible gains in welfare (no DWL)
  - (May result in undesirable distributions)
- Requires that there are no barriers to entry

Market Power

- Pricing Power: Ability of a firm (or collection of firms) to price above marginal cost and obtain above normal (i.e., zero economic) profit
  - Reduction in quantity: fewer consumers served
- Reduced quality
- Reduced rates of innovation
  - Schumpeter v. Arrow

- Associated with
  - Few firms in the market (monopoly or oligopoly)
  - Barriers to entry

Barriers to Entry

- IP (esp. patents)
- Branding
- Regulation
- Licensing
- Access to inputs/suppliers
- Sunk Costs
- Scale economies
- Learning by doing cost advantages
- Network effects (incl. platforms)

→ "Contestable markets" (maybe not literally true, but shows how concentration may be misleading measure)

US Antitrust Concerns:

- Possessing and exercising market power not illegal
  - Naturally not, if market power is had with free entry (better mousetrap)
  - Nor if entry barriers are deemed legitimate
- Acquiring market power may be illegal
  - Mergers, exclusionary practices, tying, etc.
- Efforts to maintain market power may also be illegal
  - Predatory behavior, exclusionary practices, tying, etc.

US Federal Antitrust Enforcement

with a view toward the traditional horizontal merger enforcement methodology

Antitrust Enforcement

- Private antitrust enforcement (treble damages)
- States enforcement
- Federal enforcement
- International cooperation, but no joint enforcement

Antitrust Enforcement

- Crime/Tort approach, rather than regulatory approach (affirmative act must be identified)
- Government action requires four factors (ideally)
  1. Market power (except for *per se* violations: price fixing or bid rigging)
  2. Investigated activity/behavior/conduct must be <u>profitable</u> *ex ante*
  3. Investigated a/b/c must have adverse welfare (consumer surplus) effects
  4. There must be an available remedy that is less costly when accounting for
     1. Type I and Type II errors
     2. Enforcement costs (conduct v. structural remedies)
     3. Subsequent firm conduct (evasive behaviors)

DOJ & FTC

Antitrust Division of the USDOJ:

antitrust enforcement

Sherman Act,	Sect. 1: unreasonable restraints, agreements
	Sect. 2: monopoly/monopolization
Clayton Act,	Sect. 7: Mergers

criminal prosecution (e.g., price fixing)

Federal Trade Commission:

civil antitrust enforcement (FTC Act, similar to Sherman and Clayton—but some argue a bit broader)

consumer protection (e.g., false advertising, fraud)

DOJ (ATR) & FTC

Antitrust Division of the USDOJ:

part of the executive branch of government

engaged in federal law enforcement

bring cases in Federal Courts

Federal Trade Commission:

Independent Federal Agency

ALJ (Administrative Law Judge) rule on cases, can be appealed to 5 commissioners

Cases can be Appealed to Federal Courts

DOJ (ATR) & FTC

Operate on distinct cases

But sometimes cooperate on policy issues:

- Horizontal Merger Guidelines (HMG)
- Antitrust Guidelines for Collaborations Among Competitors
- Antitrust Guidelines for the Licensing of Intellectual Property
- Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition
- Antitrust Policy Enforcement Regarding Accountable Care Organizations

Joint Statements and Hearings

DOJ (ATR) & FTC

Each sometimes works with regulatory agencies:

- FCC (Telecom)
- FAA (Airlines)
- STB (Railroads)
- SEC (Stock Markets)
- CFTC (Derivatives Exchanges)
- FERC (Energy)
- FRB (Banks; only DOJ, not FTC)
- …

Exemptions

- State Action
  - Exempts states, or private parties acting pursuant to state policy while supervised by the state (limits: see NC Dental)
- Implied Immunity
  - Can affect antitrust enforcement in regulated industries
- Filed Rate Doctrine
  - "rates on file" with regulatory agency, preclude collecting damages

- Noerr-Pennington (petitioning of government)
- Capper-Volstead (Ag Coops)
- MLB (other professional sports?)

Horizontal Merger Reviews

Hart-Scott-Rodino (HSR) Pre-Merger Notification:

- filing requirements for mergers above a certain value (periodically adjusted)
- includes (requires) extensive document deliveries
- can also apply to joint ventures (JVs)
- filed with an office in the FTC, with copies to DOJ
- is then assigned to DOJ or FTC

Merger Review: DOJ or FTC?

How is merger enforcement split between them?

Convention

Expertise

Negotiations

(yes, there sometimes are “turf wars”)

Remedies

- Structural
  - Intervenes in market structure:
    - Divestitures
    - Expansion of market access
  - Preferred method
    - Does not burden agencies with monitoring
    - May eliminate unwanted incentives towards anticompetitive behaviors
- Behavioral
  - Imposition of rules/behavioral restrictions
    - Non-discrimination, firewalls, IP-license requirements,…
  - Requires monitoring

Merger Review Timeline

Agencies have 30 days after filing to decide whether further review is required

- review of documents
- interviewing of potentially affected parties

If so, there is a "2nd Request"

- subpoena of further documents
- possible depositions
- another 30 days after compliance is certified
- (usually document production and timing are negotiated)

Review Timeline

Agencies never “approve” a merger, they let the waiting period expire, or notify parties that it will be challenged. Parties can then

- abandon the merger,
- negotiate consent decree (needs judicial approval, “Tunney Act”), or
- move to litigation

Agencies may re-open an investigation

Note:

Merger Review is inherently speculative because it is forward looking (yet, most models used are static!)

Also, agencies are both the investigative AND the prosecutorial bodies in unison – this can make for a complicated review process at times

This is exacerbated at the FTC, which is the finder of facts and the decision maker

Types of Mergers

- **Horizontal**: between competitors
  - Consolidated Edison
- **Vertical**: between buyer and supplier (i.e., firms within a supply chain)
  - TimeWarner/AOL; Enova/Pacific Enterprises
- **Conglomerate**: unrelated firms
  - These usually do not pose antitrust concerns under the Clayton Act, unless one party might be a substantial potential competitor (e.g., Google acquiring ITA (travel software))—although these cases can and are regarded as horizontal mergers
  - Different in Europe, where mergers of complements producers can be a concern (e.g., GE-Honeywell)

“Typical” Horizontal Merger Review

Five elements:

1. Market definition
2. Market Participants and Market Shares
3. Competitive Effects (← main focus in the investigation)
4. Entry
5. Failing Firm/Efficiencies

1. Market Definition

Identification of a Cognizable Antitrust Market

- Product market
  - Determined from the demand side of the market (cross-price elasticity)
  - Sometime pre-determined: banking, telecom,
- Geographic market
  - Also from demand – how far do/can people/products travel.

Hypothetical monopolist test is used for this. Look for smallest set (product or geography) that survive the SSNIP test (note that this does not give a unique answer!)

1. Market Definition

Example:

- Coke's acquisition of Dr. Pepper:
- product market: all beverages v. soft drinks v. carbonated beverages (v. just colas)

Evidence used: internal firm documents, econometric analysis, natural experiments, scanner data,…

- Staples/Office Depot merger: cross-sectional price data

2. Market Participants and Market Shares

- Sales: Including imputed shares for “rapid” entrants (but also analyzed separately when considering timely and sufficient entry)

- Capacity might be more relevant

  see, e.g., US v General Dynamics (almost depleted coal mine)

2. Market Participants and Market Shares

- HHIs are then calculated: $\sum_n (S_n)^2$, $n = 1,\ldots,N$
- From the HMG (2010):

  "Based on their experience, the Agencies generally classify markets into three types:

  – Unconcentrated Markets: HHI below 1500
  – Moderately Concentrated Markets: HHI between 1500 and 2500
  – Highly Concentrated Markets: HHI above 2500 "

2. Market Participants and Market Shares

"The Agencies employ the following general standards for the relevant markets they have defined:

- ***Small Change in Concentration****:* Mergers involving an increase in the HHI of less than 100 points are unlikely to have adverse competitive effects and ordinarily require no further analysis.
- ***Unconcentrated Markets****:* Mergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and ordinarily require no further analysis.
- ***Moderately Concentrated Markets****:* Mergers resulting in moderately concentrated markets that involve an increase in the HHI of more than 100 points potentially raise significant competitive concerns and often warrant scrutiny.
- …

2. Market Participants and Market Shares

- ***Highly Concentrated Markets**:* Mergers resulting in highly concentrated markets that involve an increase in the HHI of between 100 points and 200 points potentially raise significant competitive concerns and often warrant scrutiny. Mergers resulting in highly concentrated markets that involve an increase in the HHI of more than 200 points will be presumed to be likely to enhance market power. The presumption may be rebutted by persuasive evidence showing that the merger is unlikely to enhance market power."

  —HMG, 2012

- Note: in Europe the concern is primarily with firms in "dominant positions"

3. Competitive Effects

a. Unilateral Effects

changes in the market structure lead to *comparative static changes* in equilibrium

or a different nature of equilibrium, if a dominant firm emerges

b. Coordinated Effects

changes in the market structure leads to potential *changes in the nature* of the equilibrium (e.g., changing from non-cooperative equilibrium to collusion)

Requires that there be more than one equilibrium and coordination determines equilibrium selection

3a. Unilateral Effects

- Differentiated Products
  - Upward Pricing Pressure (UPP):
    - Prior to a merger a firm's price was limited by how many sales would be lost to rivals when increasing the price.
    - Post merger, some lost sales are "recaptured" when customers switch to the other merging firm
- Other models: e.g., Hotelling
- In any case: also consider product repositioning as a response by others

3b. Coordinated Effects

Factors that affect ability to collude:

- **shorter time periods** (making the length of time one profits from cheating shorter, and allowing rivals to punish more quickly); e.g., how often are contracts between firms and customers renegotiated
- a **growing market** (so that incentives to cheat now are lessened compared to the loss of profit under punishment in the future)
- ability to expand **capacity** quickly (otherwise punishment may be difficult) [although excess capacity is sometimes associated with declining industries]
- **small number of firms** (easier to coordinate)
- …

3b. Coordinated Effects

Factors that facilitate collusion:

- …
- **symmetric firms-**-keeps the incentives across the firms the same (otherwise smaller members of the cartel may face greater incentives to cheat)
- **market transparency** (easy to observe rivals' actions)
- **multi-market contact** (allows punishments to become more severe as they are meted out in more markets)

Agencies also use:

- past **history of collusion**

4. Barriers to Entry

- IP (esp. patents)
- Branding
- Regulation
- Licensing
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- Sunk Costs
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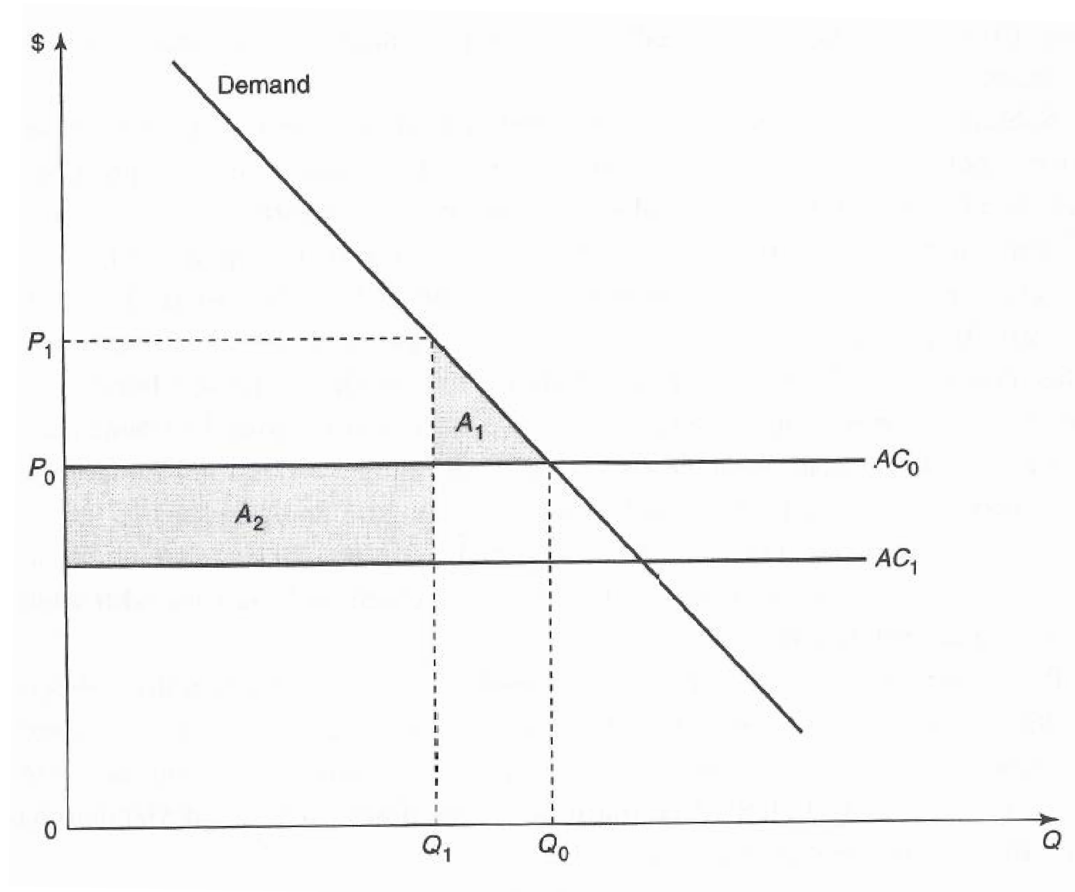
→ "Contestable markets" (maybe not literally true, but shows how concentration may be misleading measure)

→ Entry must be "timely, likely, and sufficient"

5. Efficiencies

Williamson, 1968:



5. Efficiencies

- Legal history dubious (see Brown Shoe), but currently accepted:
  - Must be extra-ordinary
    (e.g., saving by merging the HR departments doesn't count)
  - Must be merger-specific
    (it cannot be the case that the efficiencies would be attainable absent the merger)
  - Must lead to lower MC (not fixed costs)
  - If not costs, maybe network effects?

- Note Consumer Surplus, not Total Welfare Standard

- Failing firm defense

Suggested Reading

- Horizontal Merger Guidelines, 2010

  available at:

  http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf

Emerging Issues

Economic and Political Concerns

Agency Reviews with Potential Antitrust Impact

- FCC
  - Internet regulations
  - Wireless communications
  - Internet of things
- CFPB

Specific Areas of Interest Ahead:

- Pharma in general and generic drugs in particular (→ FTC 2017 Divestiture Study)
- Health insurance mergers (DOJ)
- Role of IP in national and international markets
- New Economy (Google, Amazon, other platforms)
- Further divergence between US and European enforcement?

Broader Economic Concerns

- Economic Growth and Jobs
- International Trade
- Concentration and Consumer Welfare
- Information and Privacy
- Income Inequality
- Political Influence of Corporations