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ROUNDTABLE DISCUSSION

Unilateral Effects Analysis After *Oracle*

Moderator

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JONATHAN BAKER: I am delighted that ANTITRUST magazine has assembled such a terrific group of experts to discuss unilateral effects in merger analysis. I would like to start out with Mike Vita and ask whether unilateral effects theories, such as the ones in the 1992 Horizontal Merger Guidelines,[1] are routinely employed these days in government merger investigations and which ones are the most common.

MIKE VITA: Let me first state that everything I say today represents my own views, not those of the Federal Trade Commission. As to the substance of your question, we still employ those theories when we believe they are appropriate. An example is a merger involving branded consumer products. Recent examples include the "super premium" ice cream merger[2] and a pet food merger.[3] These are the types of mergers where unilateral anticompetitive effects are plausible, and where we believe we can potentially quantify the possible magnitude of those effects through, for example, the analysis of scanner data. That is not to say we rely on those theories to the exclusion of other possible theories of harm, but they still do play a role because in many cases it is plausible that the post-merger performance would be reasonably well predicted by those models. However, we have increasingly emphasized the importance of assessing the validity of the standard methods for predicting unilateral anticompetitive effects, and I will say more about this later.

When former FTC Bureau of Economics Director Dave Scheffman came to the FTC in 2001, he and some of his counterparts in the Bureau of Competition did appear to believe that the Commission staff had been focusing excessively on identifying unilateral effects from mergers, while neglecting the possibility of coordinated effects, even when the latter might be equally, if not more, likely. I think something similar took place at the DOJ Antitrust Division. While I don't know that I agreed with Dave's perception, it is probably fair to say that for the last few years the FTC staff has

taken pains to ensure that we do not overlook the possibility that a merger might harm competition from the heightened probability of post-merger coordination.

BAKER: At least three federal district courts have expressly analyzed government allegations of unilateral effects: *Kraft/Nabisco* in the New York State challenge,[4] the *Swedish Match* case,[5] and the recent *Oracle* decision.[6] Given that the government lost two out of three of those district court cases, would you say that the validity of unilateral effects is well established or poorly established in the courts under Section 7 relative to how it is under the Merger Guidelines?

PAUL YDE: There are probably a few other Section 7 cases in which courts have addressed allegations of unilateral effects in a differentiated product setting, although the three you mentioned are probably the most explicit in addressing the Merger Guidelines' articulation. In general terms, unilateral effects analysis is very well established in the federal courts. A court will always be more comfortable with concepts that are well established in relevant precedent, and the concept of Section 7 liability based on merger to monopoly or on the creation of a dominant firm is certainly well established. To the extent that a court in a given case can reasonably describe and analyze the government's unilateral effects allegations in a manner consistent with the traditional concepts of monopoly or dominance, it will do so.

Of course, the problem for the government in pursuing cases under § 2.2 of the Merger Guidelines is that these traditional concepts were developed in cases that did not contemplate an exercise of market power through unilateral conduct by a single firm that would not meet the definition of a Section 2 monopolist. The courts have been somewhat less comfortable finding that a merger has created unilateral market power where—by the government's admission—the merged firm remains constrained by differentiated competitors (for example, in a differentiated products setting in which there are other products reasonably proximate to the products of the merging firms). In that context, the courts are less comfortable finding that a merger is anticompetitive, and probably with good reason. Section 7 law has developed largely on a coordinated effects model, with the traditional emphasis on market definition and market concentration. Economists have been saying for years that the traditional approach using traditional standards will tend to understate anticompetitive effects of mergers involving differentiated products. In unilateral effects cases in differentiated products settings, as described in § 2.21 of the Merger Guidelines, market definition (as it is usually described in case law) is not particularly important; so courts may be less adept at fitting the unilateral effects case theory into the traditional sequence of market definition and market concentration. Having said that, the Merger Guidelines' unilateral effects analysis may become better established in cases where the court can recast the essential approach into the established rubric of monopoly or dominance. I think all of this is clearly exemplified by Judge Walker's *Oracle* opinion. He used the language of dominance to describe creation of unilateral market power but then professed to use the standards of the Merger Guidelines to determine whether unilateral market power had been created.

BAKER: George, what do you think of the *Staples* decision,[7] which I know you tried for the FTC and the government won? Do you consider it a unilateral effects case that happened to be framed by the courts as a market definition question, or do you think of it as a straightforward merger to monopoly or duopoly within a narrowly defined product market?

GEORGE CARY: I do think of *Staples* as a unilateral effects case. It was cited by the lawyers for Oracle as an "arguably" unilateral effects case. They did not embrace it as a unilateral effects case altogether, but they suggested that it might be viewed as a unilateral effects case. Ultimately, I think it has to be viewed as a unilateral effects case because the proof that was put forward in defining the product market was the closeness of competition between Staples and Office Depot and the effect of that competition on prices, without regard to competition from other firms. From that basic finding, we backed into the question of what is the appropriate product market by showing that the price effects were so large that by applying a 5 percent test you could find a relevant product market that included only the office superstores. So the thrust of the evidence there was unilateral effects.

There was not a very powerful case for coordinated effects in *Staples* in the sense that there were hundreds, if not thousands, of different products sold by the retailers and there was not very good evidence that the firms coordinated their pricing with respect to each and every one of those individual items. In fact, to the contrary, the evidence showed that Staples and Office Depot aggressively competed, driving prices quite low. Furthermore, the pricing evidence in the case showed that prices were often lower in markets with just Staples and Office Depot than in markets that also included Office Max. If there were coordination, one would not expect this.

To address a point Paul made, the bottom line on this is that courts like easy cases and do not like hard cases. You can define easy cases in a number of different ways. In retrospect one might define *Staples* as an easy case (although obviously at the time it did not appear to be one) by virtue of the richness of the pricing data. Another easy case is one where you end up in a very well defined market by traditional criteria, with very high market shares, and courts also like those cases. The history of merger enforcement in the courts, though, is that when you get to hard cases, namely those where there are multiple players, maybe five or six, in a market where there is not good evidence of coordinated pricing historically, that is where the courts get a little bit nervous and queasy, and they like the security that the well-defined rules of product

market definition and concentration statistics provide them. What happened in the *Oracle* situation is that the court did not embrace that security and decided to do a pure unilateral effects analysis instead.

YDE: George, when you describe the *Staples* case as more of a unilateral than a coordinated effects case, is that a description of the way that the FTC brought the case and/or a description of the decision rendered by the court?

CARY: It is hard for me to distinguish between the two. I would say that the court "checked the boxes" set out in the historical precedent—finding a product market, measuring concentration, and applying the presumptions that flow from that historic case law. I do not think the court would have gotten there if all it were faced with was a coordinated effects case where the analysis was simply that because there is a market, and because there are high market shares, there must be a competitive problem. What drove the result was the clear evidence that competition between Staples and Office Depot mattered to actual pricing. Certainly the defendants argued that it was a unilateral effects case. On this basis, they argued that there was no precedent for what we were trying to do. I have no doubt that the judge understood it as a unilateral effects case, but in writing his opinion he adopted the vernacular of the precedent.

BAKER: Paul, a few minutes ago you were referring to Judge Walker, in his *Oracle* decision, who said that to prove unilateral effects the plaintiff has to demonstrate that the merging parties would have to obtain a post-merger monopoly or dominant position, at least in a localized competition space. He goes on to say that relevant markets defined in terms of localized competition have to be narrower than relevant markets defined in typical cases, in which a dominant position is required. Is Judge Walker saying that a plaintiff must prove a narrow market and show a merger is a near monopoly within it in order to prevail in a legal, unilateral effects case?

YDE: I think Judge Walker does say—without respect to the need to define a narrow market—that the only cognizable unilateral effect that would support a Section 7 case is the creation of a dominant firm, and that presumes there is a relevant market within which the firm is dominant. He describes in great detail what he believes is the relevant economic theory, and I understood him to say that he believes the only unilateral effect recognized by economic theory is the creation of a dominant firm. If by "dominant firm" he means a firm with the ability to raise prices unilaterally as a result of creation of market power in a merged firm, and if that means—as he says several places in the opinion—the ability to impose a small but significant and non-transitory increase in price (SSNIP), then I think that is a correct statement of the law, consistent with the Merger Guidelines, and one that seems fairly uncontroversial.

CARL SHAPIRO: I do not see any economic basis for saying that only a firm with a monopoly has any power over price. It does not make any economic sense. The economic theory of oligopoly and differentiated products, going back many, many years, shows otherwise. If this is the law, the law is very far from the economics.

YDE: What I described was Judge Walker's articulation of a cognizable unilateral anticompetitive effect for a Section 7 case, not necessarily for any other kind of case. If Judge Walker defines a dominant firm for Section 7 purposes as a firm that has the ability to impose a SSNIP as a result of the merger, then that seems uncontroversial.

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CARY: I disagree, first that it is uncontroversial, and second, that it is the law. I think that there is room in the law, by virtue of the market share presumptions that are well below dominant position or monopoly, for the conclusion that two close competitors in a broader market can potentially find it profitable to raise prices after a merger, even if not to the level of a SSNIP. There could well be a subset of customers who would be willing to pay a higher price that results from the merger and who, therefore, could be exploited even if one defined a broader market in which other firms compete and in which other firms have significant market shares. So while one can conflate the product market definition question with the anticompetitive effects question, as we tried to do in *Staples*, I do not think the law requires that conflation. And you can still have an anticompetitive effect in a well-defined broader market where two firms, because of the closeness in the product space that they occupy, can implement a price increase and get away with it.

YDE: Two comments on that. First, what you just said defines a dominant firm by reference to its share in some unspecified market rather than defining a dominant firm by reference to its ability to increase price; Judge Walker was doing the latter, as I read the opinion. Second, I do not think that there is any reason why you cannot define a broader market using the usual constructive approach and also define a narrower market pursuant to the direct prediction of anticompetitive effect. Judge Walker's opinion recognizes the possibility that a narrow market may be defined for Section 7 purposes as a subset of the differentiated products that may be included in a broader market for Section 2 purposes. In fact, he recognizes the possibility that direct evidence of anticompetitive

effects may be sufficient to attack a merger without separately constructing a relevant market. He still would require finding the creation of dominant firm which is defined by reference to the alleged anticompetitive price effect.

SHAPIRO: Here is my concern just reading these dicta Judge Walker has given us. I think there will now be a great tendency for merging parties to say: "Markets need to be defined based on reasonable substitutes, not the really narrow markets one might get through some technical exercise, through a mechanical application of the SSNIP test from the Horizontal Merger Guidelines. Properly defined, markets are relatively broad—all breakfast cereals rather than a subset of them. Viewed properly in this broader market, our merger, of course, is not a merger to monopoly, and will not lead to a monopoly or dominant position. We can easily point to at least one significant remaining rival. Yes, our merger will lead to some increase in concentration, but that is inadequate for the government to make a case based on unilateral effects." In other words, the merging parties are going to combine the language from the *Oracle* decision about the need for a dominant position with the findings in many other antitrust cases that markets must be defined based on "reasonable substitutes" and not be "artificially" narrow. I am concerned about the likely result: a huge hurdle for the government when it seeks to block mergers involving differentiated products based on a theory of unilateral effects (and great problems making a case based on coordinated effects if products are highly differentiated and pricing is complex and/or opaque). The result may well be a dramatic change in merger control policy, unjustified by any change in legislation or in economic learning.

BAKER: Judge Walker also says that in unilateral effects cases with differentiated products, it is likely to be more difficult to define the markets than we are used to. He says it may be hard to identify clear breaks in the chain of substitutes because of the many nonprice dimensions on which sellers compete, and (I am paraphrasing here) he worries that unilateral effects analysis could evolve into a misleading submarket analysis in which artificially narrow markets are defined based on noneconomic criteria having little to do with market power. Has Judge Walker set up unilateral effects as something that you can never prove, in which narrow markets have to be defined in theory but cannot be defined in practice?

CARY: Yes. That is the short answer. He's got you coming and going on that. To go back to Paul's point, the opinion clearly states that to prevail on a differentiated products unilateral effects claim, a plaintiff must prove a relevant market in which the merging parties have essentially a monopoly or dominant position. He then goes on to discuss market share thresholds and dispenses with the 35 percent standard of the Merger Guidelines as having no basis in law or economics and, therefore, rejects that benchmark because it is too low to constitute a "monopoly" or "dominant position." On the other hand, Judge Walker says that it is inappropriate to define too narrow a market, and cites cases where the courts are displeased with parties who try to define markets too narrowly; then, on the other hand, he says if the defendant does not have a dominant share you cannot prove a unilateral effects case. I agree with your conclusion, Jon.

YDE: I do not want to become the sole defender of Judge Walker's *Oracle* opinion because I think there is some internal inconsistency in his unilateral effects analysis—the mirror image of the internal inconsistency in the unilateral effects standards of the Merger Guidelines. But I think he does leave open the prospect of identifying unilateral merger effects short of proving a Section 2 monopoly. I agree that he suggests a higher standard of proof in a differentiated product setting, but this might be reasonable given that, by definition, the merging firms are constrained by reasonably proximate ostensible substitutes and the predicted price effects may be relatively small.

In this context, maybe it is more reasonable for a judge, on an ad hoc basis, to set a higher standard of proof for the definition of the relevant market. Judge Walker leaves open the possibility of identifying the unilateral effects directly from a merger simulation, for example, or from other direct evidence of the ability to raise price post-merger and then of working backward to define the relevant market as the group of products with respect to which you could impose the SSNIP. If this reading is correct, then Judge Walker's approach can be viewed as roughly consistent with the approach that would be taken at the enforcement agencies. Having said that, I recognize that some of the opinion is not helpful to the enforcement agencies in the sense that it does seem to impose a higher standard of proof in a differentiated product setting.

CARY: Price discrimination becomes really important here. Judge Walker seems to be saying either that the market must be defined broadly to include all substitutes, or that the government has to prove a price discrimination market. In either case, the merger must create a dominant firm. When the opinion talks about that "node" or "localized competition," price discrimination is central to what he is talking about. Rather than proving price discrimination markets, the government instead attempted to prove narrow markets by reference to product attributes. This left the judge unconvinced. The government could arguably have done much better if it had gone with pure price discrimination markets. That would have also dealt with the huge problems that the government ran into on geographic market definition.

BAKER: Let's take this as an opportunity to talk about the economic evidence that might be used to prove a unilateral effects case after *Oracle*. Carl, suppose you are the economic expert for the government, and you have examined bidding

records and customer testimony and conclude that the merging firms are first and second choices for a substantial group of customers. As a result, the post-merger demand curve likely grows steeper because of the merger, and you have concluded that none of the defense arguments are any good: ease of entry, rivalry positioning, efficiencies, that sort of thing. Are you comfortable at this point in testifying the merger would likely harm competition on these facts, even though you have not defined the market and analyzed concentration, or do you want more?

SHAPIRO: You have listed the key elements that economists look at to determine whether the merger is likely to cause a price increase. Depending upon the merged entity's ability to engage in price discrimination, we might see a rather large price increase for those identified customers or a more modest price increase for all of the merged entity's customers. However, in my experience as a witness, I would not be inclined to get on the witness stand and flatly decline to define the market, even though many economists think that is an unnecessary step in the economic analysis. In practice, it sounds like your fact pattern actually implies a relevant market, maybe a price discrimination market for these customers. So I also would want to ask whether the merged entity could price discriminate against the customers you identify, i.e., those who rank the merging firms as their first and second choices. Can these customers engage in arbitrage to defeat a price increase targeted at them? If, in answering those questions, we conclude that these vulnerable customers can be discriminated against effectively, then they form at least one relevant market. If they cannot effectively be discriminated against, the analysis is somewhat different.

Now we are considering the profitability of a price increase that also will apply to some customers who do *not* consider the merging parties their first and second choices. Still, oligopoly theory strongly suggests that some price increase will result, under your fact pattern. Now we are getting into magnitudes, and need to ask a series of additional questions: how many "vulnerable" customers are there relative to other customers (which will drive the Diversion Ratio), and how large are the merging firms' premerger gross margins? Remember, following the Merger Guidelines, we typically emphasize the products that are in (or out of) the relevant market, and the suppliers that are in (or out). But the third essential component of a market is the set of *buyers* who are being served in the market. In your hypothetical, even for a given set of products and suppliers in the market, the analysis is rather different depending upon the set of *customers* in the relevant market.

BAKER: Mike, Judge Walker talks about the promise of modern econometric methods generally and merger simulation methods in particular for analyzing differentiated product unilateral effects cases. He says the predictions from these methods and models may not be sensitive to market definition, which he views as a good thing. I wonder if you could talk for a moment about the use of econometric and simulation methods for analyzing unilateral effects cases, in practice.

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>
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VITA: We mostly use them internally, and of course outside parties (the merging parties, and occasionally, third parties) submit them to us. We have become much more sensitive to ensuring that those models, whether they are our own or those presented to us by third parties, do a reasonably good job of modeling the behavior in the market in question. Greg Werden, Luke Froeb, and David Scheffman recently published an article in ANTITRUST where they discuss in detail the types of internal checks that any analyst should implement when attempting to simulate post-merger behavior.[8]

The Bureau of Economics will not place much weight on a merger simulation unless it is accompanied by the kinds of robustness checks identified by Werden, Froeb, and Scheffman in that article. We also would look to see whether the predictions of the model are corroborated by the internal documents, testimony, and so forth. So, simulation might be one element of our investigation. But I think everybody here would agree that you would never rely upon simulation to the exclusion of the other types of evidence; and if the merger simulation results were the only thing you had, it would not be enough. Simulation is a potentially useful tool, but it is just one element of the information set that we rely upon when deciding whether or not to recommend a case.

BAKER: The Department of Justice's evidence in *Oracle* actually included a simulation model that was developed by an expert economist, and yet the court, for all its talk of the promise of those methods, dismissed the simulation evidence on the ground that it was based on unreliable data. So, is Judge Walker setting up simulation models as something that cannot be used in practice?

SHAPIRO: Judge Walker rejected Preston McAfee's simulation, I think in large part, because McAfee relied on Ken Elzinga's work, and the judge said that Elzinga did not get the market right. That seems to be fair enough. By downplaying the role of customer testimony and arguably emphasizing the role of this type of simulation method or expert testimony, Judge Walker has encouraged some sort of battle of the experts, and everybody who does simulation models knows there is a lot to argue about: you have to make a bunch of assumptions in those models. I do not know what judges are going to do when, inevitably, they see one expert get up with

this complex model with all these assumptions and another expert gets up and testifies that those are crazy assumptions and this whole thing is not reliable. How is a judge supposed to sort that out? Neutral experts could help a great deal.

BAKER: George, could you have won *Staples* if Judge Hogan had adopted Judge Walker's approach, which requires a merger to monopoly but might be comfortable with simulation models?

CARY: If the question is whether we could have won *Staples* without econometric models, I think the answer is "yes." But that leads you to the question of what it is that you are going to model. The model needs to be rooted in something that the judge can, by reference to accessible evidence, verify on his own, at least at some level. He should not be left to have to decide to believe one expert rather than another based on their own testimony alone. Interestingly, there seems to have been a mechanism in *Oracle* by which that could have been done. For example, PeopleSoft's pricing formula included inputs for the industry in which the customer participated, (the so-called "vertical"), the country in which the sale takes place (the geographic market), and whether the company was a big company or a small company. These parameters affected pricing. It seems to me that with that structure, one might have been able to do a statistical analysis of historical pricing data to show how each of those factors affected the real prices paid by customers. If that had proven to be the case, it could have been much more effective than merger simulation analysis to demonstrate that the products that the defense argued should have been included in the relevant market did not, in fact, belong in it. This would seem to have been a more promising approach than merger simulation that depends upon market shares as an input, which, in turn, requires that the court accept the definition of the market selected in the first place.

SHAPIRO: I want to make sure there is a clear distinction between the simulation methods versus the types of analysis that were done in *Staples*, where real world observations of differences in prices, based on differences in number of firms or market structure, were presented as evidence. The simulation methods project some price changes for market structures we have not seen yet but will see after the merger. It is a lot harder to root these types of projections in a way that a judge can see with his or her own eyes, so to speak, in comparison with the type of pricing analysis that was done in *Staples*, which did not require very many assumptions. The *Staples* analysis is what an economist would call a reduced form direct observation, which means that it did not rely on any particular underlying model of oligopoly. So, if you do not have the real-world observations as in *Staples*, and you really want to rely on these more high-tech simulation methods, judges are going to need some help. Neutral experts may be critical in providing that help.

VITA: That actually was done in one of the cereal cases, where the judge hired Alfred Kahn.

SHAPIRO: Yes, that was the Kraft/Nabisco merger.[9] I would like to see a much greater use of neutral experts in antitrust cases, especially if the courts are going to downplay customer testimony and place more weight on expert testimony.

YDE: First of all, if there is any broad conclusion to draw from what Judge Walker said about simulations, it is that he is encouraging, or at least potentially encouraging, the use of simulations where unilateral effects theory is being proposed. He explicitly recognizes that simulation models "may allow more precise estimating of likely competitive effects" and may reduce "the arbitrariness inherent in defining a relevant market." His specific treatment of the simulation proposed by DOJ's expert in that case is not significant to future cases. Walker dismissed that particular simulation based on what he thought were unreliable underlying data and analysis from DOJ's other economist. Second, if the courts are going to consider simulations as evidence in predicting unilateral effects, and if the government wants to pursue unilateral effects cases based on simulations that motivated the prosecution, then the courts absolutely need to have a neutral economist, with expertise in simulation models, to assist in evaluating the quality and utility of the simulation.

CARY: The kinds of cases that are most likely to raise unilateral effects problems are cases with highly differentiated products: where there are potentially very high fixed costs and very low marginal costs; where there are potentially very few transactions and very large transactions; and where the particular differentiation among the products might be very valuable to some customers and not others. I wonder whether merger simulations are particularly well suited for that type of market and whether that might explain why these simulations were not given much weight in *Oracle*.

SHAPIRO: The standard simulation methodology assumes there is a single price for the same product for everybody, and is not well suited to handle massive price discrimination, not to mention customized products and negotiations. I think the judge had a good instinct that the standard simulation models were not very reliable in the *Oracle* case. Properly modified simulation models can deal very nicely with bargaining, negotiations, and price discrimination, but testing the robustness and reliability of these models is complex, again implying the need for a neutral expert.

BAKER: As a legal question, can the court use, and can unilateral effects be demonstrated in court using, simulation or econometric methods without defining a market? Do you have to have a market?

YDE: As a practical matter, I think any court will require a

Section 7 plaintiff to define a relevant market in which the anticompetitive effects are predicted to occur. I think the relevant question is whether the courts will accept the approach of backing into the market definition based on the effect predicted by the simulation model. I think that is possible; indeed, Judge Walker suggests this possibility in *Oracle*. I am not saying, as a practical matter, that simulations presented to the court as the primary evidence on a unilateral anticompetitive effect are going to be persuasive. But combined with other evidence that is consistent with the simulation's results, I cannot see why you would not be able to center the analysis around the simulation's prediction of anticompetitive effect, define the market around the anticompetitive effect that has been predicted, and organize the evidence accordingly.

BAKER: We were talking before about how hard it is to prove unilateral effects under Judge Walker's approach because he simultaneously wants a narrow market and yet questions narrow market definitions. And then, we all agreed that, essentially, he likes the idea of simulations as a method of proof. Are we still in agreement that it is hard to prove unilateral effects after Judge Walker's opinion?

SHAPIRO: My article with Mike Katz, in the Spring 2003 ANTITRUST, explained how with high margins (which you certainly have in software) and high diversion ratios between the merging parties, there is a very strong economic case to be made that this situation presents a presumption of a relevant market and at least an initial theory of unilateral anticompetitive effects as well.[10] While I do not think that observing high gross margins and a high diversion ratio between the merging firms should be the end of the analysis, such a fact pattern does suggest how the merger could lead to unilateral, anticompetitive effects. I do not know precisely how strong any "presumption" of such effects should be in the presence of high gross margins and high diversion ratios, but certainly any presumption could be rebutted by adequate evidence about product repositioning, entry, or efficiencies. Simulation models might be very helpful in assessing the magnitude of any predicted post-merger price increase. I would like to see the treatment of unilateral effects in horizontal mergers move in the direction of presumptions based on evidence of premerger gross margins and evidence of direct competition between the merging firms (diversion ratios). This approach would be well grounded in oligopoly theory. However, Judge Walker seems to be moving away from such an approach by emphasizing market definition and the need to show post-merger dominance. Logically, the two approaches can be consistent if one defines narrow markets, but I wonder what evidence would convince Judge Walker that there is such a narrow market. More generally, I wonder if the courts are prepared to move in the direction of narrow markets, especially those based on price discrimination.

CARY: But in the *Oracle* case, Judge Walker gave himself, in essence, an out. He is basically saying that if there are no clear breaks in the chain of substitution, then you must define a broad market. In that broad market, if the merging firms have something other than a monopoly or a dominant position, then it can be assumed, by virtue of the inclusion of these other products in the market, that other firms could relatively easily reposition their products to make up for any minor localized loss of competition that occurs by virtue of the merger between two competitors with something other than a dominant share. So, he almost turns the presumption around. He will define a broad market, and the government must show that there *cannot* be repositioning; if you do not show that there cannot be repositioning, the default assumption by virtue of the less than dominant market shares is that there will be.

SHAPIRO: I agree. Judge Walker is making it harder for the government to bring these cases by erecting more hurdles that the government must overcome in making a case based on unilateral effects. I do not see the economic basis for his view that only a dominant firm can have any post-merger pricing latitude, given that the courts like to define markets relatively broadly. But he is the judge, he writes the opinion, and we have to deal with that.

BAKER: Are there any comments on the idea that if you can prove unilateral effects with direct evidence, there has to be some market in which the harm exists, and so for Section 7 purposes we should not worry about delineating the bounds but just proceed without doing so?

YDE: Most courts likely would not be comfortable with that approach, but I also think that there is room in Section 7 for that approach. Certainly, the federal enforcement agencies have adopted the approach in exercising prosecutorial discretion in Section 7 enforcement.

SHAPIRO: The narrower the market you end up with, the easier entry will tend to be into that market. After all, the narrower the market, the more likely we will find a firm *not* in the market that is producing a rather similar product. This firm may be able to enter the market by repositioning its product modestly, with small or moderate sunk costs. This observation is a reminder that market definition should not be the end of the analysis. Instead, it should be one step in the analysis, at least in cases where the government seeks to establish a prima facie case based on increasing concentration.

CARY: I do not think that the courts are going in the direction of eliminating the requirement that the plaintiff prove a relevant product market. I also do not think there will be a great tendency to define very, very narrow markets. The traditional way of defining markets will be with us for some time, so it is incumbent upon the plaintiffs to prove the anti-

competitive effects. Where, in my view, the *Oracle* opinion goes wrong is to assume that there just cannot possibly be an anticompetitive effect if the firm is not dominant. The law is, or should be, quite different from what the *Oracle* opinion found it to be.

SHAPIRO: I totally agree with that. Judge Walker, at the point where he refers to *Rebel Oil*, appears to be taking a Section 2 notion of market power, namely monopoly power or dominance, and porting that over to a Section 7 context.[11] Economists recognize, however, that market power is a matter of degree; there are weaker versions of market power than monopoly power. He is conflating the two.

BAKER: Carl, are you saying there are different kinds of market power for different sections of the law?

I would like to see the treatment of unilateral effects in horizontal mergers move in the direction of presumptions based on evidence of premerger gross margins and evidence of direct competition between the merging firms (diversion ratios).

—CARL SHAPIRO

SHAPIRO: Yes, different *degrees* of market power. Almost every firm has some degree of market power, unless the firm produces a homogeneous product and has a perfectly elastic demand curve. The amount of market power can go up if you buy a competitor but still be far less than what we would call monopoly power that would trigger the type of legal liabilities under Section 2 having to do single-firm conduct.

YDE: I agree with that, and it gets back to where we originally started the debate. The generous way of reading what Judge Walker said is, without respect to the specific magnitude of the price increase, a Section 7 plaintiff must show that the merger makes it more probable than not that the merged firm can impose a price increase unilaterally. Then he defines a dominant firm for Section 7 purposes as a firm that can impose a SSNIP unilaterally as a result of the merger. I recognize that it is a kind of a circular approach to defending what he said, but I think it is also the only way fully to make sense of what he has done.

BAKER: George, you think markets are not going to be defined narrowly, but Judge Hogan in *Staples* relied on *Brown Shoe*[12] factors to define something he called a submarket.

CARY: Yes, he did, and I am not suggesting that markets of that nature will not be defined. I do think, as Judge Hogan's opinion demonstrates, that where there is a clean break in substitution in the sense that there is a bundle of attributes that apply to the products at issue, all of which do not apply to the products excluded from the market, that those attributes can define a relevant market. So, at least one can identify what makes those products different, and one can say there is a clean break in substitution here. There is also precedent in the area of superstores, and there is precedent in the area of other retailers, such as supermarkets and department stores, that gave the judge some comfort in defining the market. But if there is not this clear break between the products within the market and those outside it, it is going to be very difficult to define a narrow market simply based upon the common characteristics of the products of the merging parties.

BAKER: Are submarkets, as an analytic tool, as dangerous as Judge Walker makes them out to be?

CARY: They can be misleading. If you start with the proposition that there are differences in pricing and in the extent of competition between some entities in the market relative to others, and then you can identify what it is about those entities that makes that competition different, that is a legitimate use of characteristics of the sellers and other elements of the marketplace in aid of the economic analysis. I would not, however, use the submarket criteria as a check list, where if you satisfy each element you have to find a market without regard to economic considerations. What Judge Hogan did so well in his opinion in *Staples* is to tie the *Brown Shoe* criteria to the underlying economics of competition. Plaintiffs should be required to show that the various *Brown Shoe* characteristics matter from an economic point of view and reflect real elements of competition in the marketplace on price or quality or innovation.

YDE: I agree with that. Judge Walker, in his criticism of submarkets, focused on the noneconomic use of that term in relatively ancient cases. This was an empty critique, however, because the DOJ was not employing the unstructured approach used in those ancient cases. In fact, the DOJ was attempting to achieve precisely what Judge Walker describes as the appropriate objective: presenting evidence organized pursuant to accepted economic theory to predict a merger-induced price increase.

BAKER: Perhaps we have a consensus that Judge Walker's idea that unilateral effects requires merger to monopoly or near monopoly is too tough a standard. Is Judge Walker's decision a one-time-only opinion, or is it going to be influential and, therefore, restrict the application of unilateral effects generally? What is the likelihood that other courts will follow his lead on this?

CARY: The decision will be influential. Whatever you think

of the merits, it is a carefully reasoned opinion, going to great lengths to buttress the conclusions with economics. It is carefully articulated and will be an opinion that every defendant is going to use and other judges are going to take seriously because it is not a flip or facile or simplistic analysis.

YDE: The opinion has the potential to be influential for precisely those reasons. Judge Walker is known as a judge with antitrust training and experience, and the opinion certainly has a lot of economic content. For those judges who are presented with a Section 7 complaint based on a theory of unilateral effects and who are otherwise inclined to evaluate the evidence with a pretty tough standard, the Walker opinion will be an important precedent.

VITA: To the extent that the FTC staff will face increasingly demanding standards in court, it will affect the economists I manage in terms of how they carry out their analyses. For example, customer complaints have always played a big role in our investigations and in our recommendations to the Commission. I suspect there now will be increased pressure on the staff economists, and their counterparts in the Bureau of Competition, to press customers hard to identify the basis for their opinions on, say, their likely reaction to an attempted post-merger price increase. Given the way the customer testimony was dismissed in the *Oracle* case, if that decision does becomes a model for other judges, we will have to make sure that the testimony we elicit from complaining customers can stand up to that heightened standard.

Quantitative analyses and simulations also are going to be scrutinized to ensure that they can persuade a judge who is applying these tough standards. Are the data that are going into the analysis of suitable quality? Have you checked them carefully? Have you unreasonably excluded certain types of data or certain observations? In *Staples*, for example, the difference in the conclusion reached by our econometric expert, versus that of the defense expert, turned on the fact that the defense expert excluded from his sample a large number of observations. When those observations were added back in, the results changed significantly. I suspect that this undermined the credibility of his estimates and his conclusions.

BAKER: Even with greater care in quantitative analysis and customer complaint evidence, are these approaches going to be useful and more important in a world in which Judge Walker is influential on requiring merger to monopoly or near monopoly as a basis for proving unilateral effects?

VITA: I do not want to opine on what his standards are as far as proving monopoly or near monopoly. My principal concern is ensuring that the economists I manage do their best to assemble credible evidence on whether or not prices are likely to go up in the aftermath of the transaction. And all those different kinds of evidence, whether customer complaints or quantitative analysis, will probably have to be subjected to a high level of scrutiny.

SHAPIRO: Suppose you interview a group of customers who say they would not switch outside of some group of products if prices were to rise by 10 percent. Unless those customers explain in some detail why the outside alternatives would be unattractive, even in the face of a 10 percent price increase, Judge Walker evidently would not give that customer testimony much weight. So what can the investigating staff, attorneys, and economists, do? Do we need more documents from third parties analyzing the costs and benefits of various alternatives? Does the government need to sponsor an economic expert who analyzes these options? How is that analysis supposed to deal with differences across customers in their benefits and costs of various alternatives? And how does the economic expert do all of this without extensive third-party discovery involving customers?

Back in the old days we used to wonder whether you could bring a case without customer testimony, and now we wonder if you can bring a case without econometric testimony, no matter how many customer witnesses you have.

—George Cary

CARY: It is a bit of a turnaround because back in the old days we used to wonder whether you could bring a case without customer testimony, and now we wonder if you can bring a case without econometric testimony, no matter how many customer witnesses you have. The key is that you need systematic proof that a particular customer's testimony can be generalized to the market as a whole. Obviously, you cannot bring in every customer, and you cannot, at least not often very credibly, do a poll of customers. You need some linkage of evidence, whether documentary evidence plus econometrics or documentary evidence plus customers plus econometrics; you need some combination that allows you to say that what these customers are testifying to does not apply uniquely to them, it applies across the board, and the proof of that is: (fill in the blank). The correct standard has never been "how many customers can you get to say that the merger is good or bad"; it has always been, "does the customer testimony exemplify the reality of the marketplace?" But, as a result of the *Oracle* opinion, there will be more attention paid to affirmatively showing how it is that the conclusions from a group of customers can be systematized and made consistent with other evidence.

YDE: I agree with most of that, George, but does it really tie into what Judge Walker did with the customer testimony? He

was not really focused on whether the customers who testified were representative of customers in the market. As I read the opinion, Judge Walker was not making a systematic distinction between the marginal and inframarginal customers. The biggest problem with his treatment of customer testimony—especially from the government's standpoint—is that he simply discounted the customers' expressed preferences based on the lack of supporting evidence. That is, he did not dismiss the complaining customer testimony because he concluded that those customers were inframarginal, but rather because he concluded that the DOJ had not presented sufficient other evidence to substantiate the customers' expressed preferences and predictions regarding their own conduct. I do not think that Judge Walker was focused on the question of whether they actually were representative.

BAKER: If price discrimination is important, don't we still have to define a market and understand which customers and how many customers are going to experience problems, and which ones and how many do not?

CARY: Yes, you still need to figure out what it is about these customers that makes them susceptible to that kind of anticompetitive discrimination and what it is that allows you to conclude that this is not just one or two customers but represents something about the characteristics of competition in the marketplace that we ought to be worried about from an antitrust point of view. You need to show something about characteristics that make customers vulnerable that goes beyond simply a single customer. It probably does equate to defining a market under the Merger Guidelines, but I think that is where you get back into the practical reality of litigating these cases. If the judge cannot look at it and understand why this is different from that, without a whole lot of explanation, you are likely to lose in defining a product market that narrow. In other words, without the ability to explain why discrimination is possible by reference to product as well as customer characteristics, it may be hard to sustain a relevant product market as a practical matter under the case law.

BAKER: We have been talking about two settings: first, unilateral competitive effects in the context of differentiated products, as in retail, with some firms selling close substitutes for others; and second, a variant involving bidding, which is more of the story in *Oracle*, where some buyers prefer certain sellers and not others. Would anyone like to comment on the vitality of the unilateral competitive effects theory involving homogeneous products in the Merger Guidelines, beyond merger to monopoly? For example, can you conceive of a case where a homogeneous products merger ought to be challenged based on the Cournot theory?

VITA: I suppose it is possible. The most recent FTC case involving products that were arguably homogeneous was the *Arch Coal* case,[13] but we argued there the anticompetitive effects were likely to result from post-merger coordinated interaction.

SHAPIRO: I see no reason why you would not get a Cournot-type of theory or basically unilateral effects with relatively homogeneous products. If two refineries in California, major ones, want to merge I would be concerned as a consumer here of gasoline. Yes, it might be a possibility that there would be more collusion. Of course, unilateral and competitive effects theories are not mutually exclusive. I would think it would be actually a pretty straightforward exercise to show that if two major California refineries merge then they would have a greater incentive to restrict output than prior to the merger.

MARK WHITENER [ANTITRUST Editorial Board Chair]: George, following up on a question Jon asked earlier, how do you think *Staples* would have come out if Judge Walker's analysis in *Oracle* were the law of the land, or the law of the case? Leaving aside how he looked at the facts, how do you think the case you brought in *Staples* would fare if you had to run it through Judge Walker's analysis?

CARY: It really does depend on who is right in our earlier discussion about what the *Oracle* opinion meant in its insistence on a showing of "dominance" or "monopoly." If Paul is right that it means only "dominance" of localized competition, then *Staples* should have come out as it did. But I doubt this would have been the result. I assume that Judge Walker would have found a broader market, not limited to office superstores, but inclusive of all retail sales of office supplies. There would have been proof that within that market Office Depot and Staples would have been able unilaterally to raise prices after merging because of the closeness of their formats. If that is defined as a localized competitive space, and it was shown that there would be a systematic price increase in that space, the court should come out against the deal. Nonetheless, based on my reading of what the *Oracle* court would require by way of a showing of dominance, my own instinct is that the Staples/Office Depot merger would have been approved under the rule of the *Oracle* case. The court would have found a broad market and combined shares within that market too low to meet the "dominance" or "monopoly" threshold. The court also would have assumed, whether or not there was much in the way of supporting evidence by the defense, easy repositioning by non-superstore retailers.

YDE: Without respect to the particular analysis that has been described, or the model presented, or the burdens of coming forward assigned, and so on, I think that if Judge Walker had been the judge in the *Staples* case, I agree that he would have found the other way. The *Oracle* opinion reflected a general hostility to the government's position.

WHITENER: What is the future of the Merger Guidelines' unilateral effects analysis in light of Judge Walker's pointed criticism of that analysis? In light of that critique, should the Guidelines be revised—either because Walker scored points and pointed to real infirmities in the Guidelines, or because the critique, right or wrong, in essence wounded the Guidelines and forces the agencies to revise the Guidelines to make them more defensible in litigation?

YDE: The fact that one district court in one case critiqued the Merger Guidelines is not reason enough to revise the Guidelines. But Judge Walker does raise some good questions. In particular, the use of the 35 percent share threshold in § 2.2 is what I was referring to earlier regarding internal inconsistency in the Guidelines' analysis of unilateral effects. The inclusion of the 35 percent threshold—or any market share standard—tends to create confusion about what economic logic the enforcement agencies are using in trying to predict unilateral anticompetitive effects. If the agencies are subordinating the traditional sequential approach of market definition and concentration measurement (which I think is appropriate in this context), then it is confusing, to say the least, to bring back in a 35 percent share threshold that is based on traditional concepts of market definition. The agency might attempt to prove a unilateral effect directly based on simulations and other evidence; but then by including the 35 percent threshold, the agency suggests that the court, or the Commission, should then return in its analysis to the conventional approach to market definition to determine whether it should recognize the predicted effect. That is, the agency asserts that the merger will produce a non-transitory price increase for some identified grouping of products and then, rather than defining the market on that basis, indicates that it will undertake a separate market definition exercise to see whether some arbitrary share standard—unrelated to the predicted effect—has been satisfied. This is not exactly the criticism described by Judge Walker, but his analysis seems to reflect the confusion created by the use of the share standard.

Judge Walker also suggests that the Merger Guidelines are too general in describing the conditions necessary to predicting a unilateral competitive effect. His more detailed description of the necessary and sufficient conditions is perfectly reasonable, but it is also consistent with the agencies' approach. Perhaps the agencies could be more explicit in describing these conditions.

CARY: Historically, in litigating these cases, parties have cited the case law or the Guidelines, which purported to take an economic approach to merger analysis. Parties—whether the government or the defendants—have chosen which of these authorities to cite, based upon which approach helps them win the litigation. We now have to add the *PeopleSoft/Oracle* decision as a third alternative, to the right, if you will, of the Guidelines, which stakes out its own economic ground and calls into question one of the few rules of thumb to remain in the Guidelines.

It is interesting that Judge Walker did not attempt to distinguish the 35 percent market share presumption in the Guidelines. He might have said, for example, that the 35 percent presumption makes some sense if you are dealing with traditional industrial markets, with high variable costs relative to price. In such markets, a merged firm can count on keeping a significant percentage of sales even if it raises prices post-merger, and lose only a small profit margin from any resulting lost sales. I assume there is some economics behind the 35 percent presumption along these lines. Without challenging that presumption, the court could have said that it simply does not apply in markets with very high fixed costs, very low marginal costs, and high prices relative to marginal cost. In such markets, the loss of a single sale can wipe out a significant portion of the gains from a small price increase to customers who do not switch away from the merged firm's products. Rather than accepting the Guidelines, but distinguishing them in the particular case, the *Oracle* opinion throws out the presumption by opining that there is no economic basis for 35 percent and applying a monopoly/dominance test in its place. Judge Walker's opinion should cause the agencies either to defend the 35 percent by showing its economic underpinnings, or perhaps think about modifying the Guidelines, at least in that respect.

SHAPIRO: I do not see any reason why the agencies should walk away from the Merger Guidelines' unilateral effects analysis. The agencies, though, will have to recognize that there is an opinion that has raised a lot of questions about the way that the evidence is developed and interpreted for the court.

BAKER: Should the FTC bring their next unilateral case purely administratively in order to write a good opinion and try and shape the law? Is that what is called for after *Oracle*?

YDE: I think both enforcement agencies need to be careful about where they bring any Section 7 case, and I know they appreciate that one of the most significant factors affecting the outcome of a given case is the judge to whom the case is assigned. Certainly, the FTC can control this factor to a large extent by bringing the case solely in administrative litigation. That would ensure that the adjudicated decision on the theory of anticompetitive effects is written by a decision maker who is generally familiar and sympathetic with the underlying economic theory and the FTC's interpretation. The FTC itself is probably the best bet for the government in trying to develop precedent supporting the unilateral effects theories in the Merger Guidelines. Of course, by pursuing the case purely administratively, the FTC would assume some other significant problems (including, for example, the inability to obtain a preliminary injunction against consummation pend-

ing a full trial on the merits). So, while the FTC might pursue an administrative action in a special case as a means of shaping Section 7 doctrine, I think both agencies will need to continue to think about how to win on a unilateral effects theory in a federal district court. If the agencies intend to pursue unilateral effects theories in differentiated products settings, I suppose that the *Oracle* opinion will shape the way they develop, organize, and present evidence—particularly regarding customer documents corroborating customer testimony and regarding simulation models. In my earlier comments, I was just suggesting that the *Oracle* decision also might reinforce the importance of forum selection or, at least, the significance of the predisposition of the judge assigned to the case.

WHITENER: So to borrow a phrase from the 2004 election, this was the wrong court, wrong judge, wrong time?

YDE: I am not sure there was a right court, right judge, and right time for the *Oracle* case. This was a relatively sophisticated unilateral effects theory subject to reasonable debate on its presentation and the quality of the evidence. Maybe it is a good candidate for a merger retrospective a few years from now. The most we can say right now is that this court, in the person of this judge, concluded that this was the wrong case. ■

[1] U.S. Dep't of Justice & Federal Trade Comm'n, Horizontal Merger Guidelines (1992, revised 1997), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104, *available at* http://www.usdoj.gov/atr/public/guidelines/hmg.htm.

[2] Nestle Holdings, Inc./Dreyer's Grand Ice Cream Holdings, Inc. FTC Docket No. C-4082, *available at* http://www.ftc.gov/os/caselist/0210174.htm.

[3] Nestle Holdings S.A./Ralston Purina Co., FTC Docket No. C-4028, *available at* http://www.ftc.gov/opa/2001/12/nestleralston.htm.

[4] New York v. Kraft Gen. Foods, Inc., 926 F. Supp. 321 (S.D.N.Y. 1995).

[5] FTC v. Swedish Match, 131 F. Supp. 2d 151 (D.D.C. 2000).

[6] United States v. Oracle Corp., 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

[7] FTC v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997).

[8] Gregory J. Werden, Luke M. Froeb & David T. Scheffman, *A* Daubert *Discipline for Merger Simulation*, ANTITRUST, Summer 2004, at 89.

[9] *Kraft General Foods*, 926 F. Supp. 321.

[10] Michael L. Katz & Carl Shapiro, *Critical Loss: Let's Tell the Whole Story*, ANTITRUST, Spring 2003, at 49.

[11] *Oracle*, 331 F. Supp. 2d at 1110.

[12] Brown Shoe Co. v. United States, 370 U.S. 294 (1962).

[13] FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109 (D.D.C.), *appeal dismissed per curiam*, 2004 WL 2066879 (D.C. Cir. Sept. 15, 2004).

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