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The Roles of Market Power and Market Definition in Merger Cases

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I. Why market power matters

II. How do we define market power?

III. How do we analyze market power?

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I. Why market power matters

Purpose and Goals of Competition Policy (The Big Picture)

- Goal is to **protect the competitive process**, not individual competitors.

- Goal is **economics-based** (although some jurisdictions' competition laws also promote other social goals or political (e.g., employment)).

- Goal is to **promote consumer welfare** by **preventing and remedying the illicit acquisition and maintenance of market power**.

- **Market power** is the ability of a firm profitably to raise prices above the competitive level for a significant period of time.

I. Why market power matters

Why (and When) is Competition Policy Concerned about Market Power?

- **Market power can result in:**
  - Higher prices for consumers
  - Lower output
  - Fewer choices
  - Inferior product quality and poor customer services
  - Reduce innovation

I. Why market power matters

Why (and When) is Competition Policy Concerned about Market Power?

- **But not all market power is illegal in general.**
  - Market power acquired or maintained through competition on the merits (e.g., offering a better product or service at a lower price) is not illegal.
    - Market power is the reward that incentivizes firms to compete
- **Market power is illegal when it is acquired or maintained other than through competition on the merits.**
  - **Unlawful agreements**
  - **Unlawful abuse of a dominant position**
  - **Unlawful mergers and acquisitions**
- **Thus, market power, and how it is acquired or maintained, is central to all competition analysis.**

I. Why market power matters

WHAT IS MERGER REVIEW CONTROL FOR?

- Mergers « allow firms to improve their competitiveness by generating economic efficiency gains that can have a positive impact on the welfare and purchasing power of consumers » (French Autorité de la concurrence, *Merger Control Guidelines §1*)
- But mergers may have **prospective** anti-competitive effects. This is where merger control comes in play
- **Merger control balances the efficiency and anti-competitive effects**

I. Why market power matters

What is merger control for?

- **Only mergers that increase market power need be controlled**
- **EU law:** Council Regulation (EC) No 139/2004 prohibits mergers if they “significantly impede effective competition”
- **US law:** Clayton Act Section 7 prohibits business combinations that have the potential to create or enhance substantial market power or to facilitate its exercise.

➢ Detailed market power analysis is key to *predicting* the competitive effects of a merger.

II. How do we define market power?

Economic Concept of Market Power

- The ability of a firm to raise price above the competitive level without losing so many sales so rapidly that the price increase is unprofitable.

- The ability of a firm or group of firms within a market to price profitably above the competitive level for a sustained period of time.

  - **Market**: Competition speaks of relevant markets.

  - **Profitably**: Ability to raise its price without losing so many sales as to make the price increase unprofitable.

  - **Competitive level**: Generally focus on the ability of a firm to raise price relative to the competitive level, rather than the current price level.

  - **Sustained period of time**: Distinguishes durable exercise of market power from mere "opportunistic behavior" involving the temporary elevation of prices above the competitive level that cannot be sustained over the long run.

II. How do we define market power?

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MARKET POWER IN MERGERS

- Two sources of market power in merger analysis
  - **Unilateral effects:** Measure the merged entity's ability to maintain above-market prices regardless of the behavior of competitors.
  - **Coordinated effects:** Measure the ability of competitors within the post-merger market to maintain supracompetitive prices by cooperating with each other.

III. How do we analyze market power?

Define the Relevant Market

- Competition policy deals with **"relevant markets."**

  - Market definition helps us examine and evaluate how competition is or may be harmed.

  - A relevant market has two dimensions:
    - Product dimension;
    - Geographic dimension.

  - A "relevant product" market is a group of products (services) that significantly constrain each other's pricing, when viewed from both the demand side (consumers) and the supply side (producers).

  - **Market definition focuses mainly on demand-substitution factors (French *MCG*, §308):** i.e., on customers' ability and willingness to substitute away from one product to another in response to a price increase or a corresponding non-price change such as a reduction in product quality or service (elasticity).

III. How do we analyze market power?

DEFINE THE RELEVANT MARKET

- The most common approach – both in conduct and merger investigations – is to use the **"hypothetical monopolist test".**

- HMT determines whether a hypothetical monopolist of the product would find it profitable to impose a "**S**mall but **S**ignificant **N**on-transitory **I**ncrease in **P**rice" (**SSNIP**).

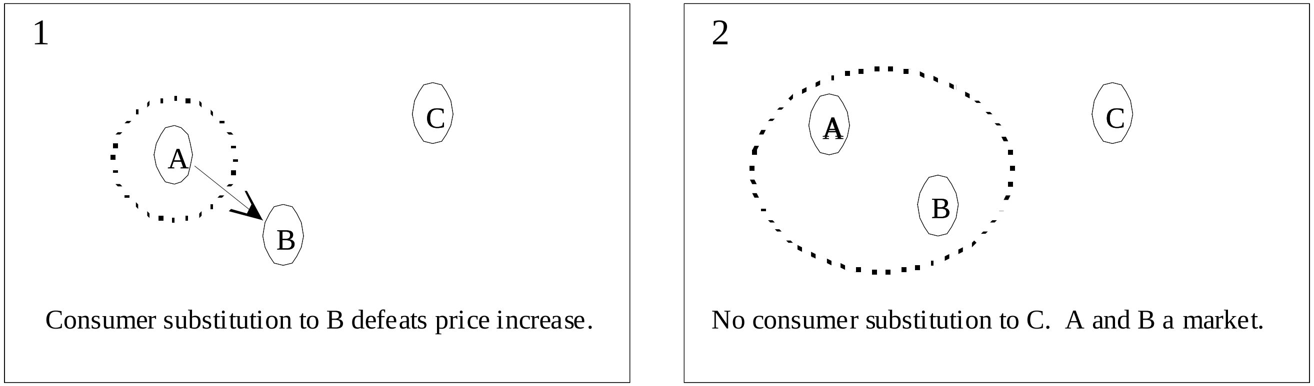
  - Generally a SSNIP is a 5% increase, but it can be higher or lower depending on the circumstances.

  - Iterative process: if not profitable, expand market to include next closet product and repeat test.

III. How do we analyze market power?

Illustration of the SSNIP Test

- "A" is a candidate product market.
- Raising A's price causes significant substitution to B (i.e., it is not profitable to impose SSNIP on Product A).
- Raising A & B's price does not cause significant substitution to C (i.e., it is profitable to impose SSNIP on Product A & B).
- Therefore, A & B comprise a relevant product market.



- Similar analysis for defining the relevant geographic market (i.e., the area that consumers can turn to for the product).

III. How do we analyze market power?

Evaluating Demand-Side Substitution

- **What products do consumers view as reasonable substitutes?**
  - Marginal versus infra-marginal consumers: generally don't worry about the infra-marginal consumers if enough marginal consumers would switch to defeat a profitable SSNIP.
- **Internal company documents relating to consumer demand** (e.g., business plans, strategy documents, etc.).
- **Natural experiments:** past price/supply shocks and how consumers responded.
  - Consumer response.
  - Competitor reaction to price changes.
- **Consumer interviews.**
- **Data analysis.**
- **Market tests.**

III. How do we analyze market power?

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Some Challenges to Market Definition

- Often perfect information/data is not available.
- Products often are "differentiated" – they are not perfect substitutes.
- Not a hard science.
- "Cellophane" fallacy (*United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377 (1956)).
  - Firm with SMP may already be pricing above competitive level.
  - SSNIP test might therefore suggest other products are substitutes.
  - However, if company's product were priced at competitive level, SSNIP would be unprofitable.
  - Can result in overly broad product markets.

III. How do we analyze market power?

MARKET SHARES

- The easiest indicator of market power are
  - market shares
  - statistical measures of concentration based on them (e.g. Herfindahl-Hirschman index)

- **But it is a crude tool, and should only be used as a first approach**

III. How do we analyze market power?

Inference of Market Power from Market Shares

- **French Law**
  - dominance presumption at 50% (*MCG* §357)
  - safe harbor presumption at 25% for horizontal mergers, 30% for vertical of conglomeral mergers (*MCG* §360)

- **US Law**
  - **Market Share Above 70 to 75%:** Sufficient to support a finding of monopoly power. *E.g., United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391 (1956).
  - **Market Share Below 30%:** Generally insufficient, standing alone, to infer that that market power exist. *E.g., Valley Liquors, Inc. v. Renfield Importers, Ltd.*, 822 F.2d 656, 667 (7th Cir. 1987).
  - **Market Share Between 40% and 70%:** Generally requires some other evidence of power in addition to the market share. *E.g., PepsiCo Inc. v. Coca-Cola Co.*, 315 F.3d 101, 108-09 (2nd Cir. 2002).

III. How do we analyze market power?

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HERFINDAHL-HIRSCHMAN INDEX

- **French and EU Guidelines:**

  For *horizontal* mergers, merger usually approved
  - if HHI is below 1 000 post-merger,
  - if 1 000 < HHI < 2 000 post-merger and HHI decreased by less than 250,
  - if 2 000 < HHI post-merger and HHI decreased by less than 150.

  For *vertical* mergers, merger usually approved if HHI is below 2 000 post-merger

- ***US Merger Guidelines* (2010 edition):** *horizontal* merger usually approved
  - if HHI is below 1 500 post-merger,
  - if 1 500 < HHI < 2 500 post-merger and H decreased by less than 100,
  - if 2 500 < HHI post-merger and there is persuasive evidence showing that the merger is unlikely to enhance market power.

III. How do we analyze market power?

The Role of Market Shares in Market Power

- **Starting point only**
  - Static versus dynamic picture of market power.
  - Limited information about degree and durability of market power.
- **Calculation of market shares** should be based on:
  - Properly defined product and geographic markets.
  - Reliable data, sources, and assumptions.
  - Measure that is best indicator of competitive conditions of the market (unit sales, dollar sales, capacity, etc.).

III. How do we analyze market power?

ASSESSING MARKET POWER
GOING BEYOND THE HIGH MARKET SHARE FIGURE

- **Many other factors need to be taken into account**
  - Pressure by competitors remaining on the market. Do they have excess capacity? Are products substitutes?
  - Clients' buying power
  - Foreclosure risks (for vertical mergers)
  - Potential competition by new entrants. Are there barriers to entry?
    - 12 December 2016: Autorité de la concurrence cleared a merger between 2 slaughtering and meat processing cooperatives
    - Problem: it created a monopoly for a certain type of beef in a specific region
    - Merger authorized under the condition that freedom be given to farmers that are members of the 2 cooperatives to choose a third-party slaughterhouse (to reduce barriers to entry)