

U.S. Horizontal Merger Guidelines

In the U.S. there are antitrust laws which govern whether mergers are allowed between firms or not. The government may review potential mergers and decide if they are allowed.

The DOJ provides "Horizontal Merger Guidelines". The current guidelines were introduced in 1992, with some minor changes made in 1997. The full guidelines are readily accessed on the web (just type in "merger guidelines" in a search engine).

The guidelines may be summarized:

1. The government assesses whether the merger would significantly increase concentration and result in a concentrated market, properly defined and measured.
2. The government then assesses whether the merger, in light of market concentration and other factors that characterize the market, raises concern about potential adverse competitive effects.
3. The government then assesses whether entry would be timely, likely and sufficient either to deter or to counteract the competitive effects of concern.
4. The government then assesses any efficiency gains that reasonably cannot be achieved by the parties through other means.
5. Finally the government assesses whether, but for the merger, either party to the transaction would be likely to fail, causing its assets to exit the market.

Legal Issues: vertical integration/constraints

There are a lot of ambiguities in legal treatment of vertical contracts.

Until 1970s, Resale Price Maintenance and Exclusive Territories were per se illegal under Sherman Act. But many states passed fair trade laws that were interpreted to cover some of these cases. Thus, although price fixing remains per se illegal, it's not always applied in vertical settings b/c it conflicts with free-trade notions between manufacturers and their distributors.

Non-price issues have been generally accepted to be ok by the courts:

- _ Exclusive territories
- _ Refusal to deal
- _ Foreclosure...

Antitrust Laws and Policy

- Interpretation of Laws (Sherman Act, Clayton Act, FTC Act) varies over time.
- Economic analysis, case by case, antitrust laws don't prohibit monopoly, they do limit activities that allow firms to acquire and maintain monopoly power.
- Antitrust cases, mostly, around whether a firm has market power. Hard to measure, definition of market, ...
- Per se rule: prohibits a certain activity (price fixing, e.g.)
- Rule of reason: vertical restraints are analyzed according to the rule of reason, requiring an investigation of the effect of the action in question.
 - If vertical restraint forecloses entry, e.g,
 - In general welfare effects are ambiguous...
- Cooperative strategic behavior: merger analysis, if the merger leads to additional market power, price fixing, ...
- Non-cooperative strategic behavior : predation, but distinguish that from competition?

Regulation

To promote efficiency. But can government regulate optimally? That is, in the context of special-interest groups?

Deregulation

Regulation, if feasible and possible, is aiming at eliminating inefficiencies and increasing welfare.

However, sometimes, due to problems of limited information, uncertainty, institutional problems, etc, regulatory laws may create distortions.

For example: regulations that are used/have the effect/ of transferring wealth from consumers to special-interest groups...

These groups have before successfully lobbied their ways into existing legislation and regulatory laws.

Example: Agricultural support programs to keep domestic prices high:

Micro-textbook example of competitive markets- agricultural products

BUT in fact government intervenes and drives outcome from competitive equilibrium.

- Subsidies paid to farmers in EU, OECD countries
- Price supports and quantity controls (graph)

Social losses are estimated to be very large!

Recent trend to deregulate- let markets work.

Average effect that is expected:

- lower average prices
- increase in output
- entry and competition
- production efficiency
- no more cross-subsidization

Application: Electricity Deregulation

The U.S. electric industry is undergoing a change in the way it delivers electricity to millions of households and businesses nationwide. The \$220 billion industry, which has been called the last great government-sanctioned monopoly, is slowly but surely being deregulated and opened to competition, giving consumers the ability to choose their electricity provider in much the same way they choose telephone carriers.

Advocates of deregulation say reducing government control of the industry will benefit consumers:

- lowering prices while expanding services
- giving the public a choice in who supplies the power that they use.

At the same time, Congress has been unable to agree on a measure to introduce competition to the electricity market nationwide.

Whether or not electricity deregulation delivers the benefits touted by its supporters – including lower prices and more services – is an open question. Rising prices, skyrocketing demand, and limited supply in some areas have raised questions about the viability of deregulation.

Application: Electricity Deregulation (cont.)

Among the 24 states that have enacted electricity deregulation plans, results are mixed:

1. Pennsylvania's deregulation experiment, enacted in 1998, has been a rousing success by most accounts. Nearly 500,000 consumers – more than 11 percent of ratepayers – had chosen to leave their utility company as of Oct. 1999, reports *The Washington Post*. In the Philadelphia area, residential customers who chose the least-expensive electricity supplier were saving about \$10 per month.

The story is much different in California, which in 1996 became one of the first states to enact an electricity restructuring plan. Not long after the plan went into effect, price increases began to whittle away public support for deregulation. Just two years after deregulation was enacted, California consumer groups succeeded in putting on the ballot an initiative that would have thrown out the state's deregulation plan. The measure failed. Criticism of deregulation intensified in the summer of 2000, when limited power supplies and increasing demand caused the wholesale price of power to soar throughout the state. In San Diego, where the retail price of power fluctuates directly with the wholesale market, electric bills doubled. The problem grew markedly worse in the winter of 2000/01, as the state's electric utilities faced a financial crisis and consumers were met with electricity shortages and skyrocketing prices.

Confidential Enron document describes power price manipulation

07-05-02 Federal energy regulators released a confidential Enron document, prepared as California's power crisis worsened, that describes how Enron traders drove up power prices. The memorandum, written by Enron lawyers in December 2000, outlined practices similar to those described by California officials who allege that the energy trading company created phantom congestion on electricity transmission lines and engaged in sham sales among its affiliates to increase electricity prices.

Describing one such strategy used by Enron energy traders and called "Death Star," the lawyers wrote: "The net effect of these transactions is that Enron gets paid for moving energy to relieve congestion without actually moving any energy or relieving any congestion." Another practice, called "ricochet," allowed Enron to send power out of California and then resell it back into the state to avoid price caps that applied to transactions solely within California. "To us, this is really the smoking-gun memo," said Sean Gallagher, a staff attorney with the California Public Utilities Commission. "It's Enron's own attorneys admitting that Enron is manipulating the California market."

Steve Maviglio, a spokesman for California Gov. Gray Davis, said the memos are more evidence that federal energy regulators should order power companies to refund billions of dollars in exorbitant electricity sales. Sen. Dianne Feinstein, D-California, asked the Justice Department to open a criminal investigation into Enron's possible manipulation of the state's electricity market. "My suspicions have been high for some time that Enron was fraudulently manipulating the California energy market for its own benefit," she said in a statement. "In the wake of this new information..., I am asking Attorney General John Ashcroft to pursue a criminal investigation to determine whether in fact federal fraud statutes or any other laws were violated by Enron."

The Federal Energy Regulatory Commission has been investigating whether Enron either took advantage of or helped spark the crisis in California's newly deregulated power markets, in which wholesale power rates jumped tenfold, three investor-owned utilities faced financial ruin and Californians experienced rolling power blackouts. Enron has denied any role in the crisis.

The company provided the memo to the commission along with a later, undated report from other Enron lawyers that took issue with the first memo. Robert Bennett, a Washington attorney who represents Enron, said the memos became known 10 days ago and could easily have been kept confidential.

The reports were addressed to Richard Sanders, Enron's vice president and assistant general counsel, to prepare for investigations and lawsuits resulting from the California situation. "Current management decided the responsible thing to do was to release the documents," Bennett said.

Source: Associated Press

HORIZONTAL MERGERS

Horizontal mergers, or horizontal integration, refer to situations when two competing firms merge together.

Examples include

1. Exxon and Mobil
2. Volkswagen and Rolls Royce and Lamborghini
3. Ford and Volvo
4. Disney and Miramax
6. Bell Atlantic and GTE Corporation to form Verizon

This is in contrast to mergers between vertically separated firms.

Examples include

1. Proposed merger between AOL and Time Warner :biggest merger ever, still being examined by FCC and FTC
2. Disney and ABC

There is actually a third class of surprisingly common mergers, between unrelated firms. This is neither horizontal nor vertical integration. We will not look at this.

Why might two competing firms choose to merge?

1. Reduce competition, allowing higher prices and higher profits?
2. Lower production costs, leading to higher profits?
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3. allowing the managers to obtain higher personal wealth?

Let us first examine more closely the first of these possible reasons: to reduce competition. One way we can clarify this possibility is to think about mergers between firms in the homogeneous goods Cournot model. That might give us some idea of the issues at least:

Assume there are $N > 2$ identical (constant marginal cost) firms initially competing in Cournot competition. There, the profits for each firm are given by

$$\pi_i = (A - c)^2 / [B(N + 1)^2].$$

Then suppose $k < N$ of these firms merge into a single firm. We assume this single firm is just like the other single firms that were not part of the merger. Now, instead of there being N firms competing with each other, there are $N - k + 1$ firms competing with each other.

The profits for each firm are now

$$\pi_i = (A - c)^2 / [B((N - k + 1) + 1)^2]$$

or equivalently $\pi_i = (A - c)^2 / [B((N - k + 2)^2)]$.

For the non-merged firms, the profit is now clearly higher (dividing by a smaller number). In this model, competing firms like it when competitors merge together.

But was the merger profitable for the k firms involved?

For the merged firms, profit is higher only if

$$(A - c)^2/[B((N - k + 2)^2)] > k(A - c)^2/[B((N + 1)^2)]$$

Which is true if

$$(N + 1)^2 > k(N - k + 2)^2$$

Say there are initially 10 firms, and 7 of them merge. Sounds like this should be profitable, since that would lower competition by a significant amount.

From the condition above $(10 + 1)^2 > 7(10 - 7 + 2)^2$, which is equivalent to $121 < 175$.

Hence, the merger is NOT profitable for the firms involved in this case!

So the Cournot model suggests there are few incentives to merge from the point of view of reduced competition leading to increased profits.

Yet we do observe many mergers in the real world. So perhaps this model is missing some important aspect.

These effects could increase the profits from merging:

- there may be cost reductions for the merged firm,
- perhaps the merged firm becomes a Stackelberg leader, and
- differentiated products (as long as merging firms are close substitutes).

The main point is, the effects on firms' profits mergers are not so obvious. The reasons for horizontal mergers can be many and varied, but it is certainly not the case that mergers are always a profitable thing for firms to do.