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Market Delineation under the NAAG Horizontal Merger Guidelines: Realities or Illusions

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MARKET DELINEATION UNDER THE NAAG HORIZONTAL MERGER GUIDELINES: REALITIES OR ILLUSIONS?

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The Reagan Administration expressed its enforcement policy for horizontal mergers in Merger Guidelines issued in 1982 and 1984 ("DOJ Guidelines"), implemented its policy through its specific enforcement actions pursuant to section 7 of the Clayton Act, and proposed to codify its policy in amendments to section 7. A substantial number of academicians, practitioners, and legislators have vocally objected to the Administration's policy, contending that it is substantially too lax. The National Association of Attorneys General (NAAG) now has gone beyond mere criticism. It has announced the intention of state attorneys general to challenge mergers they believe to be anticompetitive and has issued

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1 The 1982 DOJ Merger Guidelines are reprinted at 2 Trade Reg. Rep. (CCH) ¶¶ 4501-05. The 1984 DOJ Merger Guidelines are reprinted at 2 Trade Reg. Rep. (CCH) ¶¶ 4491-95.


its own enforcement guidelines for horizontal mergers ("NAAG Guidelines").

The NAAG's principal objection to the DOJ Guidelines appears to be that "the process of market definition in the Justice Department's Guidelines will, in many respects, overstate the bounds of both the geographic and product market in relation to the actual workings of the marketplace. This will result in the systematic understatement of market shares used in calculating market concentration." Thus, instead of proposing to challenge mergers involving lower market shares and lower levels of market concentration than those necessary to trigger enforcement action by the Department of Justice, the NAAG proposed to use roughly the same numerical standards but to delineate markets more narrowly and thereby increase market shares and concentration.

The purpose of this Article is to show that the NAAG Guidelines, not the DOJ Guidelines, produce systematic errors in market delineation. The NAAG Guidelines understate the scope of markets. Although the NAAG Guidelines proclaim their reliance on the actual workings of the marketplace and on "market realities", their quarrel with the DOJ Guidelines on market delineation reveals a pronounced blind spot and a baseless fear that the Justice Department is intent on sabotaging merger enforcement.

Section I outlines the approach to market delineation in the DOJ Guidelines, reviews how the Justice Department has applied them in cases with court decisions on the merits, and analyzes the NAAG Guidelines' criticisms of the DOJ Guidelines' approach to market delineation. Section II outlines the approach to market delineation of the NAAG Guidelines, notes many vagaries in this approach, and explains how it yields markets that are overly narrow. Finally, Section III summarizes the arguments and provides concluding remarks.

I. MARKET DELINEATION UNDER THE DOJ GUIDELINES

A. The Theory

The DOJ Guidelines start with the "unifying theme" that the goal of merger enforcement is to prevent those mergers, and only those mergers, that "create or enhance 'market power' or facilitate its exercise." Market power is defined as the "ability of one or more firms profitably to
maintain prices above competitive levels for a significant period of time." The DOJ Guidelines' approach to market delineation flows directly from this unifying theme. The primary mechanism through which mergers may create or enhance market power is the facilitation of collusion. The DOJ Guidelines, therefore, delineate markets so that market shares and concentration indices for those markets will be as meaningful as possible in an assessment of the likelihood of collusion.

In particular, the DOJ Guidelines define a market as:

[A] product or group of products and a geographic area in which it is sold such that a hypothetical, profit-maximizing firm, not subject to price regulation, that was the only present and future seller of those products in that area would impose a "small but significant and nontransitory" increase in price above prevailing or likely future levels.

The sole criterion used to delineate markets under the DOJ Guidelines, thus, is the answer to this hypothetical question: Would a monopolist or cartel over a particular product in a particular area raise price significantly? If the answer is in the affirmative, that product and that area constitute a market.

The precise procedure for implementing the DOJ Guidelines' approach to market delineation is somewhat complicated; however, the basics are quite simple. One considers in turn each product (narrowly defined) and each production point of each of the merging firms and asks whether a hypothetical monopolist of that product in that area would raise the price significantly. If the answer is yes, then the product and area constitute a market. If the answer is no, then the next best substitute product or area is added, and the question is asked again. In adding products or areas, all equally situated products or areas must be added. Exactly what constitutes a significant price increase is not explicitly defined by the DOJ

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9 1984 DOJ Guidelines § 1.0, 2 Trade Reg. Rep. (CCH) ¶ 4491.
10 For an explanation of how all of the provisions of the DOJ Guidelines flow from this unifying theme, see Werden, Merger Guidelines Present Basic Analytic Paradigm, Legal Times, June 28, 1982, at 20.
11 There surely are other ways in which mergers could create or enhance market power. For the most part, these other mechanisms do not have any different implication for market delineation. In any event, it is clear that collusion—in fact, explicit collusion—is the mechanism with which the DOJ Guidelines are concerned. See Panel Discussion, 54 Antitrust L.J. 31, 33 (1985)(remarks of William F. Baxter). The DOJ Guidelines also explicitly address the issue of single-firm market power. See 1984 DOJ Guidelines § 3.12, 2 Trade Reg. Rep. (CCH) ¶ 4493.20.
12 1984 DOJ Guidelines § 2.0, 2 Trade Reg. Rep. (CCH) ¶ 4492.
Guidelines, but generally they use a price increase of five percent lasting for one year.

For any group of products and area that constitute a market under the DOJ Guidelines, there is a family of larger, inclusive groups of products and areas, each member of which generally also constitutes a market. The reason for this is simply that a monopolist over a particular range in product and geographic space generally would raise the price at least as much as a monopolist over any smaller, included range. The DOJ Guidelines generally take the smallest group of products and area that satisfy their definition of a market to be the relevant market from any family of markets. There is a relevant market for each product and production point of each merging firm. In addition, there may be an additional, smaller relevant market if particular customer groups may be subject to price discrimination.

B. The Practice

The DOJ Guidelines' approach to market delineation is implemented by using all available evidence to answer the hypothetical questions posed. This involves two sorts of judgment calls. First, it generally is necessary to be somewhat more specific than the DOJ Guidelines themselves about what constitutes a significant price increase. Second, and far more important, it is necessary to interpret a variety of kinds of indirect evidence, since it is extremely unlikely that direct evidence will exist addressing the hypothetical questions posed.14 If there is a serious flaw with the Justice Department's approach to a market definition of the sort implied by the NAAG Guidelines, it must be with either or both of these sorts of judgment calls. Obviously, both very small and very large markets are possible if what constitutes a significant price increase can be defined arbitrarily. Thus, the best indication of whether the Justice Department actually is defining markets too broadly would be what it has done in actual cases. The only cases with readily available information of this sort are ones with court decisions on the merits. Those cases are particularly interesting because the courts' view of relevant markets can be contrasted with the Department's. There appear to be six such cases decided since the issuance of the 1982 DOJ Guidelines.15

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14 The DOJ Guidelines do not contain a formula that uses objective evidence to delineate markets. Thus, the DOJ Guidelines provide a way of thinking about the issue rather than a simple way of settling it.

15 The paucity of litigated cases has led one commentator to propose that the government be required to publish some sort of description of its analysis in each case in which additional information was requested (second request) under the provisions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a(e) (1982). See Jorde, Restoring Predictability to Merger Guideline Analysis, 4 CONTEMP. POL'Y ISSUES 1 (1986). An obvious reason why this proposal would not yield the increased information sought is that...
The first of these is *United States v. Waste Management, Inc.*,16 which actually was tried before the issuance of the 1982 DOJ Guidelines. The case involved the merger of two trash collection and disposal firms, both of which operated in Dallas and Houston. The Justice Department alleged that there were distinct relevant markets for trash collection in both Dallas and Houston for each of two types of trucks—"front load" and "roll-off". The trial court accepted the geographic boundaries of the Department's proposed market but rejected its proposed product boundaries. The court defined the market to include all "commercial" trash collection, including both of the two types of trucks the Department alleged to be in distinct markets, and other types of trucks as well. The district court found that in Dallas the merger violated section 7.17 The court of appeals upheld the district court's findings on markets and market shares, but reversed on the grounds that entry was "so easy that any anti-competitive impact of the merger before us would be eliminated more quickly by such competition than by litigation."18

The first case to be tried (at least in part) after the 1982 DOJ Guidelines were issued was *United States v. Virginia National Bankshares, Inc.*,19 in which the Department challenged the merger of two rural banks in Virginia. The Department alleged that the relevant markets were various individual banking services in Wise County, Virginia. The court rejected the geographic dimensions of the Department's proposed market in favor of smaller markets, causing the merging firms to be in two separate markets. The court, therefore, also rejected the Department's challenge to the merger.20

In another bank merger case, *United States v. Central State Bank*,21 the Department alleged that the relevant markets were two distinct products—transaction (checking) accounts and small business loans—in Benzie County, Michigan. The court found that the single relevant geographic market was the cluster of banking services in Benzie and Grand Traverse counties. As a result of the court's determination that the government's decisions normally turn on difficult factual judgments. All that could be reported, given the confidentiality requirements of Hart-Scott-Rodino (see 15 U.S.C. § 18a(h)(1982)) would be the bottom-line judgment made. In addition, some cases in which a second request is made are not analyzed very extensively. For example, the second request may reveal that merging firms do not make the same or similar products, at which point the investigation is terminated.

17 Id.
18 743 F.2d at 983.
19 1982-2 Trade Cas. (CCH) ¶ 64,871 (W.D. Va. 1982).
20 Id.
relevant geographic market was much larger than the Department has alleged, the market shares of the merging firms were found to be very small, and the merger was found not to violate the antitrust laws. The Department appealed on market delineation but to no avail.

In *United States v. Calmar Inc.*, the Justice Department challenged the merger of two producers of plastic pumps and sprayers used to dispense liquids. The Department alleged two relevant product markets—"regular sprayers" and "regular [pump] dispensers". The court found that the single relevant product market included both of these products as well as two other types of sprayers and larger pump dispensers. Even in the court's broader relevant market, the market shares and concentration were quite high, but the Department was denied the preliminary injunction it sought on the grounds that entry was very easy.

The only case in which the Department prevailed is *United States v. Rice Growers Association of California*, in which the Justice Department challenged the merger of two rice milling firms in California. The Department alleged three relevant product markets. One was the acquisition of rice for milling in California, and the court found that this was a relevant market. The other two product markets were the sale of two specific kinds of rice in the Pacific Region, and both of these were rejected by the court. On one the court found that the type of rice was not a sufficient basis for defining the market, and for the other, the court found that the geographic scope of the market was nationwide.

The final Justice Department case decided under the DOJ Guidelines is *United States v. Archer-Daniels-Midland Co.*, in which the Department challenged the acquisition by one producer of high fructose corn syrup of a long-term lease on two plants owned by another. The Department alleged that the relevant market was high fructose corn syrup in the United States. The court rejected this contention, holding that the

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22 Id.
23 The district court stated that its conclusion on the product dimensions of the market was compelled by precedent: "The Court finds that, as a matter of law, the relevant product market in this case includes the cluster of services and products that comprise the full range of services offered by commercial banks." 621 F. Supp. at 1292. The court of appeals affirmed, but held that the district court's decision was based on the facts rather than the law. 817 F.2d at 23-24.
25 Id.
26 1986-2 Trade Cas.(CCH) ¶ 67,288 (E.D. Cal. 1986). (This single victory is notable in that the defendant called no witnesses.)
27 Id.
28 No. 83-51-D (S.D. Iowa filed Aug. 6, 1987), appeal docketed, No. 87-2343SI (8th Cir. Oct. 7, 1987). The district court denied defendants' earlier motion to dismiss the case on the grounds that the lease was not within the scope of section 7. 584 F. Supp. 1134 (S.D. Iowa 1984).
relevant market also included sugar and possibly other sweeteners, granting defendants' motion to dismiss on the grounds that defendants' market shares were insufficient to establish a violation in the broader sweetener market.\[29\]

Surely these cases are not a consistent record of overly broad market delineation. All of the markets were fairly narrow. In all but one case the court found that the relevant market(s) was (were) broader than the Department contended.\[30\] Moreover, the sole exception—Virginia National Bankshares—is a case in which the Department's broader geographic market definition was essential to the finding of a violation. This record also calls into question the assertion that the Department's merger enforcement is far too lax. After all, the Department rarely wins in court when it does challenge a merger. This record also clearly demonstrates that even if the DOJ Guidelines did delineate overly broad markets as the NAAG Guidelines assert, the result would not be "the systematic understatement of market shares" and underenforcement. Incorrect markets produce incorrect market shares, but there is no assurance that increasing market size reduces the likelihood of a successful challenge. Just the opposite occurred in Virginia National Bankshares.

C. The NAAG's Case Against the DOJ Guidelines

Regretably, the NAAG Guidelines merely state a conclusion about the DOJ Guidelines, without any explanation. It is not possible, therefore, to know for sure how the conclusion was reached or to analyze the logic of the argument. However, it is fairly clear that the NAAG Guidelines' treatment of market delineation was heavily influenced by the thinking of Robert G. Harris and Thomas M. Jorde, two critics of market delineation under the DOJ Guidelines who were acknowledged by the NAAG Guidelines for "valuable comments, suggestions and advice on the initial drafts."\[31\] Harris and Jorde had previously reached a conclusion virtually identical to that in the NAAG Guidelines:

\[29\] No. 83-51-D (S.D. Iowa filed Aug. 6, 1987). [This case does not appear to be reported even in CCH.]

\[30\] A similar pattern also can be seen for merger cases adjudicated by regulatory agencies rather than litigated. For example, the Department of Justice opposed two airline mergers on the grounds that they would substantially lessen competition. In both cases, the Department contended that the relevant market was limited to nonstop service. The Department of Transportation found that neither merger would substantially lessen competition and generally included one-stop service in the relevant market. TWA-Ozark Acquisition Case, Order No. 86-9-29 (Dept. of Transportation, Policy & Int'l Affairs, Sept. 12, 1986). NWA-Republic Acquisition Case, Order No. 86-7-81 (Dept. of Transportation, Policy & Int'l Affairs, July 31, 1986).

At every one of the major steps and at most of the subsidiary ones, the [DOJ] Guidelines use procedures which have the effect of increasing the size of the market, and therefore of reducing the shares of the merging firms in the market. Although in some cases the [DOJ] Guidelines' methods may produce unbiased results, it is uniformly true that whenever there is a possibility of bias, it is always in the same direction of market expansion.32

Harris and Jorde also supply an explanation for this conclusion that the DOJ Guidelines delineate overly broad markets. They assert that the DOJ Guidelines are part of an unprincipled attempt to reduce merger enforcement.33 The NAAG Guidelines seem to have adopted Harris and Jorde's conclusion and explanation as their own.

The argument put forth by Harris and Jorde consists almost entirely of a series of misstatements about the DOJ Guidelines interspersed with explanations of how the wrongly imputed approach would lead to incorrect conclusions. The analysis offered is essentially correct, but it is used to critique a phantom.34 Let us consider briefly each of Harris and Jorde's points that relate to market size.

The first of Harris and Jorde's arguments is that the DOJ Guidelines “lack institutional realism” and thereby overstate the extent to which economic agents would react to price changes.35 Harris and Jorde do not point to any specific language in the DOJ Guidelines that, in their view, exhibits this lack of realism, and it appears that there is no specific offending language. The DOJ Guidelines' approach to market delineation plainly seeks to determine what actually would happen if a monopolist came into existence. The only thing hypothetical about the inquiry is the hypothetical monopolist. Harris and Jorde's criticism appears not directed at the DOJ Guidelines themselves, but rather at how the Justice Department is expected to apply them. In addressing the difficult issues

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33 Id.
34 The point is not that Harris and Jorde were malicious, but rather that they were misinformed. It also must be acknowledged that the 1982 DOJ Guidelines were not a model of clarity on market delineation. However, drafting problems were remedied in the 1984 DOJ Guidelines, and any misimpressions conveyed by the DOJ Guidelines' explanations could be corrected through reference to their definition of a market (see text accompanying note 12 supra). This definition was not substantially changed from the 1982 DOJ Guidelines. See 1982 DOJ Guidelines, n.6, 2 Trade Reg. Rep. (CCH) ¶ 4502 n.6. That definition, in turn, was fully explained in Werden, supra note 13.
35 Harris & Jorde, supra note 32, at 476-79. Harris and Jorde make a very similar point about possible barriers to reacting to price increases under the rubric of “intermarket mobility”. See id. at 484-85.
posed by the DOJ Guidelines, Harris and Jorde believe that the Justice Department will too readily conclude that sellers will take advantage of opportunities to increase profits and that buyers will take advantage of opportunities to cut costs. To the extent there is objective evidence as to the behavior of economic agents, there is no reason to believe that the Department or the courts will ignore it. Absent objective evidence however, optimizing behavior seems the best assumption, indeed the only principled assumption possible.36

Second, Harris and Jorde argue that the 1982 DOJ Guidelines' procedure of defining a "provisional market" and then expanding it could produce overly broad markets because the "provisional market" could be too broad.37 The logic is correct, but the premise is not. The DOJ Guidelines did not intend for the "provisional market" to be anything but a very narrow group of products that could not possibly be too small. However, the 1982 Guidelines did contain language suggesting otherwise, and it was revised in the 1984 version. The Guidelines now state that the "Department will begin with each product (narrowly defined)" and with "the location of each merging firm", and there is no mention of a "provisional market".38

Third, Harris and Jorde argue that the DOJ Guidelines may yield overly broad markets if they ask whether a specific (e.g. five percent) price increase would be profitable for a hypothetical monopolist rather than whether a price increase of at least that much actually would be imposed by a hypothetical monopolist.39 Again their logic is faultless. It is quite possible that, for example, a five percent increase would not be profitable but a larger price increase would be profitable and thus would be imposed.40 Again Harris and Jorde were misled by the poor drafting in the 1982 DOJ Guidelines which was corrected in the 1984 version. The DOJ Guidelines' definition of a market is now clearly keyed to whether a hypothetical monopolist "would impose" a significant price increase.41

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36 An example illustrates the choice the Department and the courts must make. Suppose that an executive replied in the negative when asked whether his firm would begin selling its product in a particular area in the event of a price increase. Suppose further that the objective evidence revealed no reason for the answer given and clearly showed that the firm would profit from acting contrary to the executive's prediction. What should one conclude? Probably that the executive has not thought the matter through and is mistaken. Of course, if the executive has a good reason why the apparent profit opportunity is really not attractive, there may be ample reason to accept his conclusion.

37 See Harris & Jorde, supra note 32, at 479-81.


39 See Harris & Jorde, supra note 32, at 483.

40 For a complete explanation of the circumstances, see Werden supra note 13, at 542-45 & nn.93-94.

41 See supra note 12 and accompanying text. The earlier version was based on whether
Finally, Harris and Jorde argue that the DOJ Guidelines will delineate overly broad markets when market power already is being exercised because the DOJ Guidelines use the prevailing price rather than the competitive price as a benchmark. However, the DOJ Guidelines permit the use of the competitive price if it is a "likely future price", and in assessing the likely effects of a merger, the prevailing price is the correct benchmark otherwise. The issue is whether the merger will make things worse, and how bad things already are is irrelevant unless, absent the merger, they are likely to improve.

When the points based on misconceptions are eliminated, Harris and Jorde's criticism of the DOJ Guidelines' approach to market delineation seems to boil down to a single point. They believe that the Department of Justice will be much too willing to dismiss forces limiting reactions to a price increase and, thus, inclined to overestimate those reactions. It is difficult to respond to an attack on thought processes. The best available evidence on the Department's actual practice is in the cases it has litigated, and they do not appear to exhibit what Harris and Jorde predict.

the hypothetical monopolist "could increase its profits" through a significant price increase. See 1982 DOJ Guidelines n.6, 2 Trade Reg. Rep. (CCH) ¶ 4502 n.6.

This is not an exhaustive list of Harris and Jorde's criticisms. It merely recounts all those that they directly or indirectly relate to the conclusion that the DOJ Guidelines yield overly broad markets.


For a fuller explanation of the point, see Werden, supra note 38, at 651-53. See also Baxter, Responding to the Reaction: The Draftsman's View, 71 CALIF. L. REV. 618, 623-24 n.35 (1983); R. Posner, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 128-29 (1976). There is a situation in which it is appropriate to use the competitive price in merger analysis—the mergers of two firms that compete to some extent, but are not in the same market. See Werden, supra note 13, at 525-26 n.43. See generally Werden, Section 7 of the Clayton Act and the Analysis of "Semihorizontal" Mergers, 27 ANTITRUST BULL. 135 (1982).

One specific aspect of their argument is that the DOJ Guidelines assume away certain information imperfections. See Harris & Jorde, supra note 32, at 481-82. This could be a serious defect in the DOJ Guidelines, depending on how they are interpreted. See Werden, supra note 13, at 547 & n.108. The 1984 revisions, however, make it clearer that the significance of the assumption was limited to the tolling of the time period portion of their price-increase significance threshold: "In attempting to determine objectively the effect of a 'small but significant and nontransitory' increase in price, the Department in most contexts will use a price increase of five percent lasting one year . . . For the purposes of its analysis, the Department will assume that the buyers and sellers immediately became aware of the price increase." 1984 DOJ Guidelines § 2.11, 2 Trade Reg. Rep. (CCH) ¶ 4492.101.
II. Market Delineation Under the NAAG Guidelines

A. Basic Premises and Procedures

Unlike the DOJ Guidelines, with their single unifying theme, the NAAG Guidelines seek to address a multitude of potentially conflicting goals. They appear, however, to be animated by only one of them: "The central purpose of [section 7] is to prevent firms from attaining market power or monopoly power, because firms possessing such power can raise prices to consumers above competitive levels, thereby effecting a transfer of wealth from consumers to such firms." Although the logic and wording differ from those of the DOJ Guidelines' unifying theme, no significant differences relevant to market delineation are apparent. Thus, for the NAAG Guidelines to achieve their purpose, they must deem a group of products and an area to be a market if, and only if, it is possible to possess market power over them.

The NAAG Guidelines describe the process of product market definition in the following paragraph:

The Attorneys General will determine the customers who purchase the products or services ("product") of the merging firms. Each product produced in common by the merging parties will constitute a provisional product market. The provisional product market will be expanded to include suitable substitutes for the product which are comparably priced. A comparably priced substitute will be deemed suitable and thereby expand the product market definition if, and only if, considered suitable by customers who account for 75% of the purchases.

The NAAG Guidelines describe the process of geographic market definition in the following paragraphs:

First, the Attorneys General will determine the sources and locations where the customers of the merging parties readily turn for their supply of the relevant product. These will include the merging parties and other sources of supply. To this group of suppliers and their locations will be added suppliers of buyers closely proximate to the customers of the merging parties. In determining those suppliers to whom the protected interest group readily turn for supply of the relevant product, the Attorneys General will include all sources of supply within the past two years still present in the market.

Utilizing the locations from which supplies of the relevant product are obtained by members of the protected interest group,

46 NAAG Guidelines § 2, Special Supp., supra note 5, at S-3, S-4 (footnotes omitted).
47 NAAG Guidelines § 3.1, Special Supp., supra note 5, at S-5 (footnote omitted).
the geographic market will be defined as the area encompassing the production locations from which this group purchases 75% of their supplies of the relevant product.\textsuperscript{48}

Additional "submarkets" are permitted in both cases if price discrimination is possible.\textsuperscript{49} Although far from clear on this point, the NAAG Guidelines might allow additional firms to be added if they would begin selling in the market in the event of an exercise of market power,\textsuperscript{50} but their market shares will be limited to the quantity they would sell in the defined market.\textsuperscript{51}

\textbf{B. Questions Left Unanswered}

It is rather difficult to determine from the descriptions provided by the NAAG Guidelines exactly how one is supposed to go about delineating markets. Consider the very first step of the delineation of the product dimensions of markets. One must identify products produced by both merging firms. Without having delineated markets, however, it is not clear how one is to know whether the firms produce the same product or different products unless, of course, they produce identical products. Assuming one gets past this stumbling block, the next step is to add "comparably priced" substitutes. Unfortunately, one is given no clue as to how to determine whether two prices are comparable. Finally, the market is defined to include other products if, and only if, they are considered suitable by customers accounting for 75% of purchases, but no test for suitability is provided. Are we to assume a price increase as under the DOJ Guidelines, and if so, of what magnitude? And how are we to measure purchases? It could be number of transactions, number of units purchased, or total dollars of purchases.

Despite all the vagaries in delineating the product dimensions of markets, the NAAG Guidelines are even vaguer on delineating the geographic boundaries. First, one is supposed to determine where the customers of the merging firms "readily turn for their supply of the relevant product." If the merging firms are multiplant, it is not clear whether this exercise is to be done at the plant or firm level. Of course, the operative phrase "readily turn" is not defined. Then one is to add locations "proximate to the customers" of the merging firms, but one is not told how to define "proximate". Finally, the geographic boundaries of the market are defined as "the area encompassing the production locations from which the [protected interest] group purchased 75% of their supplies of the relevant product." The "protected interest group" is

\textsuperscript{48} NAAG Guidelines § 3.2, Special Supp., supra note 5, at S-6.

\textsuperscript{49} NAAG Guidelines §§ 3.11, 3.22, Special Supp., supra note 5, at S-5--S-6.

\textsuperscript{50} NAAG Guidelines § 3.3, Special Supp., supra note 5, at S-6--S-7.

\textsuperscript{51} NAAG Guidelines § 3.4, Special Supp., supra note 5, at S-7.
not defined, but one may infer that it is the customers of the merging firms and perhaps similarly situated customers as well. Again, what one is to take 75% of is not defined. But the biggest problem is that, however the protected interest group is defined and whatever one takes 75% of, "the area encompassing the production locations from which this group purchases 75% of their supplies" is not well defined. In general, there will be thousands of such areas with a dizzying variety of sizes and shapes, and we are not provided the slightest hint as to which one is to be used. Finally, it appears that the last step of the process does not require the preceding step; the last step uses only locations of buyers and the preceding step defines locations and sellers.

C. The Consequences

It is easily seen that the application of the NAAG Guidelines could result in the delineation of markets that are overly narrow. They are overly narrow based not merely on some abstract notion of what the proper market is; they are too narrow to serve as intended in determining whether mergers are likely to raise prices to consumers. In most cases, they will be overprotective of consumers in that they will result in challenges to mergers that are not reasonably likely to result in price increases. In some cases, however, overly narrow markets will cause likely increased prices to consumers to be overlooked and truly anticompetitive mergers to go unchallenged.

Before elaborating these points, a threshold problem with the NAAG Guidelines' approach to market delineation should be noted. They may overlook competition between the merging firms if the merging firms produce imperfect substitutes. This is due to the fact that the NAAG Guidelines do not define relevant markets for each product of each merging firm. They delineate markets only for "[e]ach product produced in common by the merging" firms. If the products of the merging firms are defined very narrowly, this practice sometimes will result in failing to delineate markets for, or otherwise to analyze, mergers that could increase prices to consumers. Of course, this problem can be avoided by defining products broadly, but such a practice sometimes would result in beginning the process with an overly broad group of products—a result the NAAG Guidelines rightly seek to avoid. Thus, it is essential to begin with narrowly defined products and, therefore, improper to consider only common products of the merging firms.

52 The NAAG Guidelines seem to take the position that challenging mergers that are not anticompetitive is not a problem because the courts will uphold their legality, while failing to challenge mergers that are anticompetitive is a problem because private enforcement cannot be expected to be a backstop. See NAAG Guidelines § 3 n.20, Special Supp., supra note 5, at S-5 n.20.
If markets are delineated under the NAAG Guidelines, their product dimensions are likely to be overly narrow for two basic reasons. First, the NAAG Guidelines improperly use pairwise comparisons. They start with a product and ask whether individual substitutes are in the same market. By contrast, the DOJ Guidelines would ask whether available substitutes are sufficiently good that the product is not a market. The distinction may seem trivial, but it can be profound. Suppose that two sellers of bagels are proposing to merge and that a tiny increase in bagel prices would cause sales to fall to virtually zero because customers would substitute bread, danish, croissants, and doughnuts in roughly equal amounts. The DOJ Guidelines require at least one of the substitutes to be added to the market, but the NAAG Guidelines would stop at bagels because no single substitutes attracted “customers who account for 75% of the purchases.” Clearly, the NAAG Guidelines yield a market that is overly narrow, which could lead to the challenge of a merger that poses absolutely no threat to consumers. Suppose now that the merger is between a bagel firm and a croissant firm and that most (but less than 75% of) bagel customers would switch to croissants if bagel prices rose while the rest would switch to bread, danish, and doughnuts. In this case, the NAAG Guidelines again yield a market that is overly narrow, but this time they would fail to challenge a merger that could increase prices to consumers.53

The second basic reason that the NAAG Guidelines delineate the product dimensions of markets overly narrowly is that they employ an unreasonably restrictive criterion—the 75% rule. The NAAG Guidelines add a product to the market only if they are considered “suitable by customers who account for 75% of the purchases.” The preceding discussion explained that pairwise tests for market delineation are inappropriate, so it is necessary to assume that the defect is corrected before proceeding. Thus, we may restate the test to be that a “provisional market will be expanded by the addition of the next-best substitute if available substitutes are considered suitable by customers accounting for 75% of consumption.” This still leaves a serious problem of application, since what is “suitable” is not defined. For the purpose of discussion we may assume that some price differential standard like that in the DOJ Guidelines is used and that the standard itself is unobjectionable.54

53 The NAAG Guidelines certainly are not alone in using pairwise comparisons. The old standard of cross-elasticities of demand inherently involves pairwise comparisons and, therefore, is improper. See Werden, supra note 13, at 572-73.

54 It seems unlikely that this is what the NAAG has in mind, because it would have been a simple matter to adopt the DOJ Guidelines’ standard. A more restrictive test probably was intended, and it most likely would not use a price increase standard. It is necessary, however, to make some assumption before proceeding and unfair to assume an erroneous standard.
Even after being recast in the most favorable light, however, the 75% standard presents serious problems. To see this one need only consider by how much a monopolist would restrict output below the competitive level. If less than a 75% restriction would be imposed, then the 75% test it too restrictive. For arbitrary demand and cost functions, the percentage output restriction that a monopolist would impose could be anything between 0 and 100%. Obviously, the theoretical extremes are not a sufficient basis for a general rule of thumb. A better guide may be found in reasonable, simple cases. Once such case is that of linear demand and constant marginal costs. In this case, the monopoly produces exactly half the competitive quantity. Another reasonable, simple case is that of constant elasticity of demand and constant marginal cost. In this case output will be restricted between 63% and 100%, with a restriction in excess of 75% only for a rather narrow range of elasticities of demand (from one to two). Constant elasticity demand curves are concave. If instead we consider convex demand curves with constant marginal cost, the output restriction is less than 50%. The output restriction is less,  

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55 There would be no output restriction if a capacity constraint held output at the monopoly level. There could be a nearly 100% output restriction if marginal cost was constant and demand almost perfectly elastic at all outputs above some tiny amount and relatively inelastic below that quantity.  

56 Let $p =$ price, $q =$ quantity, and $c =$ marginal cost. A linear demand function can be written  

$$p = a - bq,$$

where $a$ and $b$ are positive constants. Under competition, price equals marginal cost. Thus, by substituting and rearranging, we see that the competitive quantity,  

$$q^c = (a-c)/b.$$  

A monopolist equates marginal revenue with marginal cost. The monopolist's total revenue is simply $pq$ or  

$$TR = aq - bq^2.$$  

By differentiation, marginal revenue,  

$$MR = a - 2bq.$$  

Thus, the monopoly quantity is  

$$q^m = (a-c)/2b = q^c/2.$$  

57 A constant elasticity demand function is of the form  

$$p = aq^{-e}$$

where $e$ is a positive constant and is the (negative) elasticity of demand. The competitive quantity is derived by equating price and marginal cost and is  

$$q^c = (c/a)^{1/e}.$$  

The monopoly quantity is derived as before, noting that  

$$TR = aq^{1+1/e},$$

$$MR = (1+1/e)aq^{1/e}.$$  

Thus, we have  

$$qm = [(c/a)(1/(1+e))]^{1/e}.$$  

The ratio of the monopoly quantity to the competitive quantity, thus, is  

$$1/(1+e)^{1/e}.$$  

The quantitative results in the text are derived by substituting values of from just over 1 to infinity into this expression. There is no solution for values of 1 or less.
often far less than indicated above if marginal cost is increasing rather than constant or if the basis of comparison is not competition, but rather some intermediate between competition and monopoly. Either of these modifications would increase the difference between price and marginal cost and thereby increase the forgone profit for each unit of output reduction.

Clearly, the 75% rule is often too restrictive, resulting in overly narrow markets. Moreover, it is not restrictive enough in some cases, resulting in overly broad markets. If it were necessary to use a single numerical standard for the reduction in quantity, 75% is probably too high. Something in the range of 30% to 50% seems best. However, no single quantity-restriction standard works in all cases, and it would be wiser not to have such a hard-and-fast rule. Some flexibility is useful, and the DOJ Guidelines have that flexibility. Situations in which monopolies would restrict quantity quite often can be identified rather easily. They are likely to have roughly constant marginal cost and a highly elastic demand at the current price but a much less elastic demand at higher prices. Such a demand structure can be expected only if there are excellent substitutes for most but not all customers at current prices, but not good substitutes for the remaining customers even at significantly higher prices.

The delineation of the geographic boundaries of markets under the NAAG Guidelines also is likely to produce overly narrow markets. Although the NAAG Guidelines are not clear on this, it appears that they define the geographic boundaries of the market as an area encompassing the production locations of at least 75% of the consumption of some group of customers. Exactly what group of customers is unclear as is which of the many areas satisfying this criterion is to be used. One is forced to speculate somewhat, but the idea seems to be that only sellers (or possibly also potential sellers) to the undefined customer group can be relevant competitors and not even all of them are relevant. Whatever was meant, it seems clear that the NAAG Guidelines would define the geographic boundaries of markets too narrowly in many cases.

An example makes the point. Assume that identical buyers and identical sellers both are uniformly distributed throughout a large area. Further posit that each consumer purchases one unit of the relevant product and purchases it at the factory gate of the seller with the lowest delivered price. Finally, assume that sellers have constant production costs per unit with no fixed costs and constant transportation costs per unit of distance. In this example, if all sellers charged the same price, as under competition, each buyer would purchase from that seller located at exactly the same point as it is. The “protected interest group” for any seller would be that seller’s single customer and perhaps adjoining customers. The sellers to the protected interest group would be just those sellers at the same points as the protected interest group. So, for the merger of two neighboring sellers, the NAAG Guidelines would define a
market encompassing 75% of these sellers. While not at all clear, the NAAG Guidelines might add additional sellers that would sell to the protected interest group in the event of an exercise of market power. This, however, would make no significant difference.

Even if we give the NAAG Guidelines the benefit of the doubt on this, and even if we use a 100% test rather than 75%, it is clear that the result is still not correct. Having not specified any actual economic data, e.g., the cost of transportation, it is not possible to know what the correct market is. What is clear, however, is that the NAAG Guidelines have ignored much of it. The problem is that, absent price discrimination which both the NAAG and DOJ Guidelines consider separately, the protected interest group is protected from exercises of market power by the surrounding buyers. A price increase to the protected interest group would also be a price increase to the surrounding buyers and their decrease in purchases often would deter the price increase.

To make matters more concrete, consider a cartel or hypothetical monopolist including all sellers within radius $r$ of two adjoining merging firms. As $r$ increases from zero, the price increase that would be imposed also increases from zero. How fast it rises depends on per unit transportation costs, $t$. If $t$ is small enough, $r$ would have to be arbitrarily large before a significant price increase would occur. If $t$ is high enough, even low values of $r$ would yield large price increases.\textsuperscript{58} Note, however, that the NAAG Guidelines' market is independent of $t$, since the protected interest group and who would sell to them is not affected. Unless $t$ is very large indeed, the NAAG Guidelines will include but a tiny fraction of the area encompassing the sellers that actually determine the price to the protected interest group.

In the case of the merger postulated, the NAAG Guidelines could greatly exaggerate the likelihood of a price increase to consumers by delineating the market overly narrowly. Of course, the reverse is possible as well. If the merging firms were not adjoining, then the NAAG Guidelines easily could miss the merger's effect on competition.

A final, general point also should be made about the tendency of the NAAG Guidelines to delineate markets that are overly narrow. The introduction to the market delineation discussion of the NAAG Guidelines emphasizes that judgments should be made on the basis of historical experience rather than likely future conduct:

Markets should be defined from the perspective of those interests section 7 was primarily enacted to protect, i.e., the classes of consumers (or suppliers) who may be adversely affected by an

\textsuperscript{58} The optional nondiscriminatory cartel or monopoly price would be $c + rt/3$, where $c$ is marginal production cost. Since the competitive price is equal to $c$, the price increase suffered by consumers is $rt/3$. 

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anticompetitive merger. The Attorneys General will utilize historical data to identify these classes of consumers ("the protected interest group"), their sources of supply, suitable substitutes for the product and alternative sources of the product and its substitutes. The market thus defined will be presumed correct unless rebutted by hard evidence that supply responses within a reasonable period of time will render unprofitable an attempted exercise of market power.*

*Hard evidence, as contrasted with speculation, is generally grounded in historical fact. Hard evidence of a probable supply response would include a factual showing that this response had occurred in the past when prices increased significantly. A mere prediction that a manufacturer will shift his production from one product to another to capitalize on a price increase, when unsupported by evidence of a previous similar response or other information of similarly probative nature, is not considered "hard evidence."59

While one may agree that mere speculation should not be relied upon, the insistence on historical evidence goes much too far.

Most American markets are fairly competitive, and thus mergers typically arise in fairly competitive markets. History generally will reveal no attempts to exercise market power, so it is unlikely that historical evidence can directly answer the difficult questions posed by section 7. Unless there has been a fortuitous change in relative prices (due, for example, to a change in costs) that simulated the effects of an attempted exercise of market power, historical evidence will be unavailing. If only historical evidence is good enough, then substitution possibilities that actually would prevent the exercise of market power will be systematically ignored. The result again is that markets are defined overly narrow.

III. SUMMARY AND CONCLUSION

The NAAG Guidelines are a response to the perceived laxity of the Department of Justice's merger enforcement policy, and the specific standards of the NAAG Guidelines are a reaction to the perceived source of the Department's failure—market delineation. Analysis of the NAAG and DOJ Guidelines reveals that the primary, if not exclusive, point of contention is how the delineation of markets should consider the likely responses of buyers and sellers in an attempt to exercise market power.

69 NAAG Guidelines § 3 & n.22, Special Supp., supra note 5, at S-5 & n.22.
The DOJ Guidelines and the Department’s application of them are seen by the NAAG as ignoring important constraints on these responses—“market realities”—and consequently producing overly broad markets. However, an examination of the DOJ Guidelines themselves and their application in litigated cases does not reveal any basis for the NAAG’s concern. But even if the reverse were true, the NAAG Guidelines would not represent a moderating influence on the radicalism of the Justice Department. Rather, the NAAG Guidelines are an extremely radical and ill-conceived backlash.

They are a radical backlash because they frequently yield markets that are overly narrow by standards that the NAAG and DOJ can agree on. The NAAG Guidelines’ markets are overly narrow for two basic reasons. First, the specific standards in the NAAG Guidelines for delineating markets are seriously flawed in a variety of ways that can cause them to delineate overly narrow markets. Second, in assessing the available evidence regarding the likely effects of an attempt to exercise market power, the NAAG Guidelines close their eyes to effects—no matter how likely—that have not been observed in the past. In both of these ways, the NAAG Guidelines have forsaken any claim of moderation or, indeed, of reliance on market realities. Real effects are routinely ignored.

The NAAG Guidelines’ approach to market delineation is ill-conceived for many reasons. The NAAG Guidelines are a reaction to what appear to be serious misconceptions about the DOJ Guidelines and how they are applied by the Department of Justice. The NAAG Guidelines’ approach to market delineation also is very incomplete, poorly exposited, or both. All important terms and concepts were left undefined. Most importantly, as a result of an erroneous approach to market delineation, the NAAG Guidelines will not effectively achieve their purpose of preventing price increases to consumers that could result from mergers. By delineating markets that are overly narrow, the NAAG Guidelines frequently will yield the impression that a merger is likely to increase prices when it is not. Moreover, in some cases, they will yield the impression that truly anticompetitive mergers pose no risk of raising prices to consumers.

Whether the Justice Department or its critics are correct about the overall level of merger enforcement activity is beyond the scope of this Article and probably unknowable. Given the present state of knowledge about the competitive effects of mergers, it certainly is not possible to prove that the NAAG is wrong. Thus, there is nothing inherently irresponsible or dishonest about the NAAG’s call for stricter enforcement. The same cannot be said for the NAAG Guidelines and the NAAG’s assertion that merger enforcement is too lax because of defects in the DOJ Guidelines’ approach to market delineation. Both are premised on a baseless fear that the Justice Department has somehow sabotaged the process to accomplish an ulterior purpose of scuttling merger enforce-
ment. The NAAG's views concerning market delineation are not grounded in market realities, but rather in illusions about the DOJ Guidelines.