Importing the Merger Guidelines market test in section 2 cases: potential benefits and limitations

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One essential element of any monopolization claim under section 2 of the Sherman Act is monopoly power in a relevant antitrust market.[1] The definition of the relevant market in Sherman Act section 2 cases is often of signal importance in determining the outcome of the controversy. As in merger cases, the purpose of

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1 *See* United States v. Grinnell Corp., 384 U.S. 563, 570–71 (1960) ("The offense of monopoly under § 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident").

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the market definition exercise in a section 2 case is to identify all of the important restraints on the ability of the defendant to exercise market power. A definition of the market that is too broad will lead to an underestimation of the size and power of the defendant. A market defined too narrowly will usually have the opposite effect.

For more than half a century, the Supreme Court has grappled with relevant market issues, producing a somewhat disjointed and often confusing body of case law attempting to define useful economic criteria. Faced with similar problems, in 1982, the Department of Justice, Antitrust Division, issued significantly revised Merger Guidelines "describing the analytical foundations of merger enforcement and providing guidance enabling the business community to avoid antitrust problems when planning mergers." Among other innovations, the 1982 Merger Guidelines introduced a systematic method for defining economically relevant markets, i.e., markets that could be subject to a meaningful exercise of market power. The Merger Guidelines were further revised in 1984 and 1992, and the 1992 Merger Guidelines were jointly issued with the Federal Trade Commission.[2]

Since its creation, the Guidelines' market definition test has been utilized by several courts in merger cases.[3] A LEXIS search of all federal cases, however, reveals no cases in which the market test in the Guidelines was applied in a monopolization setting. This apparent reluctance is somewhat surprising given the courts' difficulty developing a practical market definition test of their own, and the comparative rigor of the Guidelines' method. No doctrinal justification supports the courts' reluctance. As early as 1966, the Supreme Court observed that there is "no reason to

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[2] *See* U.S. Department of Justice and Federal Trade Commission, 1992 Horizontal Merger Guidelines, 57 Fed. Reg. 41522-01 [hereinafter Guidelines].

[3] *See, e.g.*, Consolidated Gold Fields, PLC v. Anglo Am. Corp., 698 F. Supp. 467, 501 (S.D.N.Y. 1988); United States v. Rice Growers Ass'n, 1986-2 Trade Cas. (CCH) ¶ 67,288 (E.D. Cal. 1986); Bon-Ton Stores, Inc. v. May Department Stores Co., 1994-2 Trade Cas. (CCH) ¶ 70,800 (W.D.N.Y. Nov. 30, 1994).

differentiate between line of commerce in the context of the Clayton Act and part of commerce for purposes of the Sherman Act."[4] Thus, the task of defining relevant antitrust markets for each type of case is also analogous. Why, then, haven't the courts utilized the Guidelines' test in section 2 cases?

This article maintains that, so long as one understands its inherent limitations, judicial application of the Guidelines' market definition test can be instructive in nonmerger cases. Section I below provides a brief description of the Guidelines' approach to market definition. Section II summarizes the judicial pronouncements on market definition and identifies certain areas of confusion in those pronouncements. Section III discusses how, if properly applied, the Guidelines' test can avoid these areas of confusion. Finally, section IV identifies some limitations in the Guidelines' approach and discusses how misapplication of the test in nonmerger cases can be avoided.

I. The Merger Guidelines' approach to market definition

The Guidelines represent an attempt to bring merger analysis under section 7 of the Clayton Act more into line with modern economic thinking. The Guidelines were authored in large part by economists employed at the antitrust enforcement agencies.[5]

The stated purpose of the Guidelines is to identify economic dangers posed by mergers that may "create or enhance 'market power' or . . . facilitate its exercise."[6] "Market power" is defined as the ability to profitably raise price above competitive levels.[7] That "market power" could result from either an increased unilateral ability to raise price or from an industry structure more conducive to collusive activities. It has long been recognized that

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[4] United States v. Grinnell Corp., 384 U.S. 563, 573 (1966).

[5] *See* Gregory J. Werden, *Market Delineation and the Justice Department's Merger Guidelines*, 1983 Duke L.J. 514 (1983).

[6] *See* Guidelines § 0.1.

[7] *Id.*

market power is constrained by the ability of customers to substitute away from a price increase by buying different products or the same products from more distant suppliers (demand substitution), or by buying from additional sellers attracted by the increased price (supply substitution). The Merger Guidelines set out an integrated multistep procedure designed to analyze these issues.

As the first step in the analytical process designed to determine when market power may be created or enhanced by a proposed merger, the Guidelines call for defining the relevant markets. According to the Guidelines, a market:

> is defined 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 regulations, 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.[8]

That is, the relevant market has both a geographic and a product component. If, in a given geographical area, a sole provider of a particular product could profitably raise its price a "small but significant" amount (e.g., 5%), then that product is a relevant market for that geographical area.

A. *The narrowest market concept*

The procedure set forth in the Guidelines is as follows: Starting with a particular product of one of the merging firms, the analyst asks whether a hypothetical monopolist would find it profitable to increase prices of that product above the current levels by approximately 5%. If the answer is yes, that product is deemed a relevant market for further consideration, and the analyst moves on to the next product.[9] If the answer is no, the product, in and of itself, is deemed too narrow to constitute a relevant market, and the set of products is broadened to include the next

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[8] *Id.* § 2.0.

[9] *Id.* § 1.11.

best set of substitutes and the process is repeated. The analyst inquires whether a sole provider of both the product and the next best set of substitutes could profitably increase price by 5%. If yes, that set of products is deemed a relevant market. If no, the next best set of substitutes is again added and the process is repeated.[10] Thus, a relevant product market is the *smallest* set of products for which a hypothetical monopolist would find it profitable to increase prices by 5%. The analysis continues until markets are delineated around each of the products of each of the merging firms. The two sets of product markets are then compared to determine whether the two merging firms are participants in any of the same product markets. If they are, the merger is deemed "horizontal" and analysis of any potential anticompetitive effects resulting from the merger continues.

Geographic markets are defined in an analogous manner. Beginning with the location of each merging firm, the analyst asks whether a sole provider of the relevant product could raise its price by 5%. If not, the geographic area is expanded to include the next best substitute for production and the analysis is repeated.[11] This process continues until the test is satisfied. For any given merger, there can be multiple relevant product and geographical markets, each addressing a different possible exercise of market power.

B. Supply-side substitution

The Guidelines' mechanism for dealing with potential supply-side responses to an exercise of market power is also noteworthy. In defining the relevant product market, the Guidelines focus directly on demand-side substitution—the reaction of the consumer to an increase in price. Supply-side substitution responses to attempted exercises of market power—supplier reactions to price increases—are considered in separate sections of the Guidelines dealing with the identification of firms in the relevant

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[10] *Id.*

[11] *Id.* § 1.21.

market and the likelihood of new entry.[12] This is accomplished by including among the participants in the defined market not only those firms presently producing products in the relevant market, but also those firms that are "uncommitted entrants."[13] Uncommitted entrants are firms that, in response to a 5% price increase and without the expenditure of significant sunk costs, would likely supply the relevant product within 1 year. The likelihood, timeliness and sufficiency of longer-term supply responses (i.e., within 2 years) are addressed in the entry section of the Guidelines. This longer-term supply response is also considered because, as recognized in the Guidelines:

> A merger is not likely to create or enhance market power or to facilitate its exercise, if entry into the marketplace is so easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels. Such entry likely will deter an anticompetitive merger in its incipiency, or deter or counteract the competitive effects of concern.[14]

C. Calculation of market shares

Once the firms that participate in the relevant markets have been identified, each firm's market share is calculated. Market shares are typically calculated as each firm's share of total sales or current capacity in the market. These market shares are then used to calculate the Herfindal-Hirschman index of market concentration (HHIs) for the postmerger market and the change in concentration resulting from the merger. The Guidelines consider postmerger HHIs of 1800 to represent highly concentrated markets.[15] Mergers in such markets that increase the HHI by more than 100 points are rebuttably presumed to create market power.[16]

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[12] *Id.* §§ 1.3 & 3.0.

[13] *Id.* § 1.32.

[14] *Id.* § 3.0.

[15] *Id.* § 1.51.

[16] *Id.*

II. The judicial approach to market definition

In contrast to the Guidelines' approach, Supreme Court precedent presents a less precise and somewhat disjointed approach for defining the relevant market. In 1962, though having addressed the issue in earlier cases,[17] the Supreme Court, in *Brown Shoe Co. v. United States*,[18] prescribed certain general guidelines for defining relevant markets. Finding that Congress neither adopted nor rejected any particular test for defining the relevant market when it amended section 7 of the Clayton Act in 1950, the Court offered its own criteria:

> The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross elasticity of demand between the product itself and substitutes for it. However, within this broad market, well defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes.[19]

The Court's definition is less than precise. Two particular areas of confusion are apparent from subsequent applications of this test. First, unlike the Guidelines' approach which focuses on the smallest set of products in which an exercise of market power may occur, the *Brown Shoe* test refers more broadly to the concept of demand substitution and expressly acknowledges the potential for relevant "submarkets." Second, unlike the Guidelines' approach which excludes supply-side substitution from the product market definition process but includes it in identifying the market participants and calculating market share, judicial decisions give no consistent guidance on supply-side considerations, sometimes ignoring them entirely, and other times incorporating them directly into the product market definition exercise. Each of these areas of confusion is discussed separately below.

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[17] *See* United States v. E.I. du Pont de Nemours & Co., 351 U.S. 377, 404 (1956) (*Cellophane*) (the relevant market is "composed of products that have reasonable interchangeability for the purposes for which they are produced—price, use and qualities considered").

[18] 370 U.S. 294 (1962).

[19] *Id.* at 325.

A. *Potential for submarket confusion*

Brown Shoe contemplates that a "broad market" can include relevant "submarkets" that "may be determined by examining such practical indicia as industry or public recognition of the submarket as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes and specialized vendors."[20] In practice, this pronouncement has fostered confusion among the lower courts. Some courts have interpreted the so-called *Brown Shoe* indicia as prescribing a method of detecting cross elasticity of demand for defining the relevant market itself.[21] While other courts have interpreted the indicia as a way of appending an additional market concept, a submarket, to the standard cross elasticity test.[22]

Under either approach, the entire concept of a *sub*market is potentially confusing. If a market is defined to include all products (and geographic areas) that compete with one another, then what is a submarket? If a submarket includes all products that mutually constrain pricing, then why consider anything broader? By definition, a submarket consists of a subset of the products included in the relevant market. It must, therefore, ignore some effective substitutes that constrain exercises of market power. Since the ultimate purpose of the market definition exercise is to identify all the important constraints on the potential exercise of market power, a large market share in a submarket will fail to

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[20] *Brown Shoe*, 370 U.S. at 325. Chief Justice Warren had emphasized the importance of such indicia in his dissenting opinion in *Cellophane*. Warren's dissent relied heavily on the fact that du Pont itself had recognized the distinctiveness of *Cellophane*. Justice Warren could have been reacting to the overinclusiveness of the *Cellophane* approach when writing for the majority in *Brown Shoe*. *See* discussion in SCHWARTZ, FLYNN & FIRST, ANTITRUST: FREE ENTERPRISE AND ECONOMIC ORGANIZATION 110 (6th ed. 1983).

[21] *See, e.g.*, U.S. Anchor Manufacturing v. Rule Industries, 7 F.3d 986 (11th Cir. 1993).

[22] *See, e.g.*, F.T.C. v. Coca-Cola Co., 641 F. Supp. 1128, 1133 (D.D.C. 1986); Tasty Baking Co. v. Ralston Purina, Inc., 653 F. Supp. 1250, 1258–60 (E.D. Pa. 1987).

identify a number of real constraints and therefore overstate the competitive danger. Accordingly, misleading inferences can be drawn from market share data within submarkets.

Moreover, the seven *Brown Shoe* indicia listed by the Supreme Court for defining submarkets—(1) industry recognition of a submarket, (2) peculiar characteristics and uses, (3) unique production facilities, (4) distinct customers, (5) distinct prices, (6) sensitivity to price changes, and (7) specialized vendors—are for the most part not well suited for identifying whether products compete or are substitutes. Indeed, close inspection indicates that indicia six is actually the same as the cross elasticity test that is supposed to define the relevant market itself.[23]

B. *Integrating supply-side factors*

In addition to the submarket problem, judicial precedent is also unclear and inconsistent regarding the proper manner in which to integrate supply-side factors into market analysis. In *United States v. Columbia Steel Co.*,[24] the Supreme Court addressed supply substitutability in defining the relevant market in the context of the acquisition by U.S. Steel of Consolidated Steel Company, the largest independent steel fabricator on the west coast.[25] U.S. Steel, through its subsidiary Columbia Steel, had been the largest rolled steel producer in the Pacific coast area since 1930. Consolidated, on the other hand, was a major west coast consumer of rolled steel products.[26] The government contended that U.S. Steel's contemplated acquisition of Consolidated would unreasonably restrain competition by foreclosing other producers of rolled steel products from supplying the requirements of Consolidated.[27]

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[23] *See* L. Maisel, *Submarkets in Merger and Monopolization Cases*, 72 Geo. L.J. 39 (1983).

[24] 334 U.S. 495 (1947).

[25] *Id.* at 498.

[26] *Id.* at 501, 508.

[27] *Id.* at 508.

The case in large measure turned on the definition of the relevant market. The government contended that the market must be limited to certain types of rolled steel products (namely, plates and shapes), while U.S. Steel argued that all rolled steel products must be included. Under the government's proposed definition, Consolidated's consumption represented 13% of the market, while, if all rolled products were included, Consolidated's share dropped to 3%.[28] The Court rejected the government's proposed market definition, holding that, because the same production facilities were used to make all of the rolled products, the relevant product market must include all rolled steel products, not just plates and shapes. The Court stated:

> If rolled steel producers can make other products as easily as plates and shapes, then the effects of the removal of Consolidated's demand for plates and shapes must be measured not against the market for plates and shapes alone, but for all comparable rolled products.[29]

Having thus expanded the relevant market, the foreclosure resulting from the acquisition was deemed "insubstantial" and therefore not unreasonable.[30] Importantly, in assessing the potential anticompetitive effects of the acquisition, the Court focused not on the consumers' ability to substitute other rolled steel products for plates and shapes, but rather on the competing suppliers' ability to shift their production to other types of rolled steel products.

Since *Columbia Steel*, judicial consideration of supply-side factors in defining the relevant market has been spotty and analytically imprecise. Some courts appear to have ignored supply-side considerations altogether. As recent as 1989, one court observed that "[a] review of case law indicates that the vast majority of antitrust cases have used cross-elasticity of demand as the *sole factor* for determining the relevant product market,"[31] and one

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[28] *Id.* at 509.

[29] *Id.* at 510.

[30] *Id* at 511, 527.

[31] United States v. Syufy Enterprises, 712 F. Supp. 1386, 1398 (N.D. Cal. 1989) (emphasis added). Though acknowledging that the Supreme Court's *Columbia Steel* decision makes "reference to the use of what can only be termed 'cross elasticity of supply,' " the *Syufy* court goes on to

prominent commentator recently opined that, "[w]hen judges measure market power, they often ignore elasticity of supply or else they have difficulty in stating the relevant concerns."[32]

Other courts, though acknowledging the theoretical validity of considering supply-side factors in defining the relevant market, find no real place for it in their market analysis. One such case, *United States v. Bethlehem Steel Corp.*,[33] involved a proposed acquisition virtually identical to the *Columbia Steel* case that would have combined Bethlehem Steel and Youngstown Sheet & Tube Company. The government opposed the merger contending that each steel product constituted a separate "line of commerce" and that the merger's competitive effects needed to be analyzed with respect to each such market.[34] The defendants, invoking *Columbia Steel*, argued for a broader market definition based on supply substitutability contending that there were several finished steel products that could be interchangeably manufactured by the same production facilities.[35] The court, while paying theoretical homage to supply-side factors by acknowledging that "competition . . . always involves interplay among and between both buyers and sellers," endorsed the supremacy of demand-side factors, holding that "[a]ny definition of line of commerce which ignores the buyers and focuses on what the sellers do, or theoretically can do, is not meaningful,"[36] and adopted the government's position

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conclude that "[t]his factor has been mentioned in only a handful of cases since *Columbia Steel* as one possible factor to be used in conjunction with cross elasticity of demand in analyzing the relevant product market." *Id.*

[32] HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE at 105 (1994). *See also* Note, *Telex v. IBM: Defining the Relevant Market*, 61 IOWA L. REV. 184, 198 (1975) ("[E]ven at the present time [some 20 years after *Columbia Steel*], [supply-side] substitutability has not gained general acceptance as a criterion for definition of the relevant market").

[33] 168 F. Supp. 576 (S.D.N.Y. 1958).

[34] *Id.* at 589.

[35] *Id.* at 589–90, 592 n.29.

[36] *Id.* at 592.

based almost exclusively on demand-side factors.[37] Though this approach is directly contrary to economic theory (which accepts the importance of supply elasticity), it continues to appear in judicial opinions.[38]

In the last approximately 20 years, however, there appears to be an increase in the number of courts expressly incorporating

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[37] *Id.* at 593. The *Bethlehem Steel* court also based its decision in large measure on its belief that "line of commerce" under § 7 of the Clayton Act was not the same as the "line of commerce" mentioned elsewhere in the antitrust laws. The court stated:

> Equating the language of section 7 to the concept of market does not, however, mean that the section 7 market is the same as the market for purposes of other sections of the antitrust laws. Nor is the section 7 market necessarily the same as the economist's concept of market. . . .
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> The section 7 market can only be defined in the light of its overall objectives and with particular recognition that it is being defined for the purpose of determining the reasonable probability of a substantial lessening of competition and not for the purpose of determining whether monopoly power will exist as a result of the merger.

Id. at 588. *See also id.* at 592 n.34 (distinguishing *Columbia Steel* on the same basis). The continued vitality of this reasoning is in doubt in light of the Supreme Court's subsequent statement in *Grinnell* that there is "no reason to differentiate between line of commerce in the context of the Clayton Act and part of commerce for purposes of the Sherman Act." United States v. Grinnell Corp., 384 U.S. 563, 573 (1966).

[38] *See, e.g.*, L.G. Balfour Co. v. FTC, 442 F.2d 1, 11 (7th Cir. 1971) (relying on *Bethlehem Steel* and other cases to reject market definition argument based on cross elasticity of supply, opining that the "alternative source of supply test . . . has been rejected by the courts as the only standard to be used for definition of the market"). In 1981, the 7th Circuit reaffirmed this approach in Kaiser Aluminum & Chemical Corp. v. FTC, 652 F.2d 1324 (7th Cir. 1981), even though it acknowledged that "failure to recognize cross-elasticity of supply alone as a sufficient foundation for a market definition may be questioned as not supported by sound economics." *Id.* at 1330 n.5. *See also* Fineman v. Armstrong World Industries, Inc., 980 F.2d 171, 198–99 (3d Cir. 1992) (outlining "legal contours of a relevant product market" without reference of any kind to supply-side considerations).

supply-side considerations into the market definition process.[39] These courts, however, seem to still be struggling with the precise analytical construct in which to consider supply substitution. In large measure, those courts that have undertaken a supply-side analysis have used the concept to broaden the scope of the relevant product market—including within the relevant market the *product* that the anticipated new entrant would substitute production from, rather than employing the Guidelines' approach and including the new entrant among the market *participants*, and including that entrant's production capacity in assessing the defendant's market power as reflected by its market share.

One such early case is the Ninth Circuit's decision in *Twin City Sportservice, Inc. v. Charles O. Finley & Co.*[40] In that case, the court rejected the district court's definition of the relevant market and remanded the case with express directions to include supply-side considerations in its analysis of the relevant market.[41] Citing to *Columbia Steel*, the court stated:

> While the majority of the decided cases in which the rule of reasonable interchangeability is employed deal with the "use" side of the market, the courts have not been unaware of the importance of substitutability on the "production" side as well.[42]

In addition, the court outlined the analytical construct in which the supply-side factors should be considered:

> [T]he degree of substitutability in production is measured by cross-elasticity of supply. Substitutability in production refers to the ability of firms in a given line of commerce to turn their productive facilities toward the production of commodities in another line because of simi-

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[39] *See, e.g., In re* Municipal Bond Reporting Antitrust Litigation, 672 F.2d 436, 441 (5th Cir. 1982); Calnetics Corp. v. Volkswagen of America, Inc., 532 F.2d 674, 691 (9th Cir. 1976); United States v. Empire Gas Corp., 537 F.2d 296, 303 (8th Cir. 1976); FTC v. Owens-Illinois, Inc., 681 F. Supp. 27, 46 (D.D.C. 1988); Bhan v. NME Hospitals, Inc., 669 F. Supp. 998, 1018 (E.D. Cal. 1987).

[40] 512 F.2d 1264 (9th Cir. 1975).

[41] *Id.* at 1272–74.

[42] *Id.* at 1271.

> larities in technology between them. Where the degree of substitutability in production is high, cross-elasticities of supply will also be high, and again *the two commodities in question should be treated as part of the same market.*[43]

Thus, the court directed inclusion of both the substituted for product and the demanded product within the relevant product market, rather than including the likely new entrant as a market participant and including the entrant's production capacity in assessing the defendant's market share. This same approach has been applied by other courts incorporating supply-side considerations in defining the relevant product market.[44]

In summary, judicial treatment of supply-side factors in market definition has been inconsistent. When courts have applied supply-side analysis they have done so by expanding the number of products in the relevant product market, as opposed to the Guidelines' approach in which supply-side substitution is uni-

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[43] *Id.* (emphasis added).

[44] *See, e.g.*, J.H. Westerbeke Corp. v. Onan Corp., 580 F. Supp. 1173, 1187 (D. Mass. 1984) ("*Products* that are produced in common facilities should be included in the same market where the facilities are freely convertible from one product to the other." "So long as the potential to shift production exists, the *products* produced in a common facility should be included in the same market") (emphasis added); Virtual Maintenance, Inc. v. Prime Computer, Inc., 957 F.2d 1318, 1327 (6th Cir. 1992) (rejecting the district court's product market definition limited to a particular type of computer aided design system because of competitors' abilities to develop and supply like systems, and holding that "[d]efining a market, or 'submarket,' on the basis of demand considerations alone is erroneous because such an approach fails to consider the supply side of the market. . . . The relevant product market cannot be determined without considering the cross-elasticity of supply"); United States v. Empire Gas Corp., 537 F.2d 296, 303–04 (8th Cir. 1976) (relying on *Columbia Steel* in declining to include electricity and natural gas within the same product market as liquefied petroleum gas (LP) because "the cost of constructing new natural gas pipelines and of converting LP-using facilities to electricity [makes] the cross-elasticity of supply between these energy sources and LP . . . low, at least for the present"; and noting that "cross-elasticity of supply would seem to be as important as the demand factor in determining the relevant product market").

formly considered in identifying the market participants, rather than in defining the relevant product market itself.

III. Potential benefits from applying the Merger Guidelines

The step-by-step framework set forth in the Guidelines offers a potentially beneficial construct to aid judges in defining relevant markets in antitrust cases and weeding through the sometimes obtuse precedential gloss on the antitrust laws resulting from nearly a half century of judicial opinions. For example, application of the Merger Guidelines can help bring clarity to the otherwise confusing Supreme Court precedent dealing with so-called submarkets and substitutability of supply.

A. *Elimination of submarket confusion*

As explained above, the concept of a submarket contained within a market has been a source of confusion since its announcement in *Brown Shoe*. To appreciate how the Guidelines' approach to market definition avoids this confusion, it is helpful to explore what may have led to development of the submarket concept in the first place. Two possibilities come to mind, both of which are effectively handled under the Guidelines' approach without resort to development of a submarket.

First, the submarket concept may have evolved from the failure of preexisting precedent to provide adequate guidance concerning what degree of substitution or cross elasticity is required to include or exclude a product from the relevant market. The courts developed the relevant market analysis in order to analytically connect market performance (exercise of market power) with market structure. This is accomplished by drawing inferences from market shares. For example, if a defendant's market share in the relevant market is above some threshold (usually above 70%), then monopoly power is assumed.[45] The inference that is drawn

[45] *See, e.g.*, International Boxing Club of New York, Inc. v. United States, 358 U.S. 242 (1959) (81% market share); United States v. American Tobacco Co., 221 U.S. 106 (1911) (86% market share); United States

from a large market share depends on the size of the relevant market, i.e., what products are included. While judicial decisions dictate inclusion in the relevant market of all products that are reasonable substitutes for each other and direct an examination of cross elasticity, they provide no guidance on what degree of cross elasticity is the cutoff or how weak a constraint on pricing a substitute product must be before it is excluded as a "reasonable" substitute. Moreover, existing jurisprudence does not appear to appreciate that the inference that can be drawn from a large market share depends on the implicit cutoff or standard each court decides to use to judge whether a substitute is close enough to the defendant's product to be a "reasonable substitute." In contrast, as explained below, the Guidelines avoid this imprecision and inconsistency by dictating, albeit arbitrarily, a single standard (the 5% test) so that inferences that are drawn from market shares about industry performance will be consistent from case to case.

Moreover, courts do not have the luxury of dealing with these complex issues in the rarified air of academia. Because the proper boundaries for the relevant market is probably the single most contested issue in antitrust cases, courts are typically faced with two very divergent relevant market alternatives—plaintiffs offer a narrow market definition drawn tightly around the defendant's product, while defendants advocate a much broader market including every conceivable functional substitute. Each litigant offers ample support for its position. The lack of a clear market boundary leaves plenty of room for dispute, and the absence of clearly defined judicial standards for defining markets leaves the court with little coherent direction.

Under these conditions, it is not surprising that the concept of a submarket evolved.[46] A simple example illustrates the relevant issues and demonstrates how the concept of a submarket might arise as a court attempts to compensate for the lack of rigor in accepted market definition standards. Suppose a court, persuaded by the defendant's proffered definition, concludes that the rele-

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v. United Shoe Machinery Corp., 347 U.S. 521 (1954) (75% market share).

[46] *But see supra* note 20.

vant market is very broad, including products A, B and C (the ABC market). The court finds that a monopolist over A, B and C could profitably increase prices by 30% before substitution toward product D, the next best substitute, would begin to significantly erode sales. However, because there are several suppliers of product C, market concentration in the ABC market is low. Thus, the court finds it unlikely that monopoly power could be exercised in the ABC market.

Suppose further, however, that the court, persuaded somewhat by plaintiff's argument for a narrower market, finds that a monopolist over just products A and B could profitably raise prices by 5% over competitive levels before competition from product C could begin to hurt sales. In addition, presume that, unlike the ABC market, there are an extremely limited number of suppliers of products A and B, and the court, therefore, concludes that there is a significant risk of monopolistic behavior over products A and B. To address this concern, which is not otherwise addressed by the ABC market analysis, the court may be inclined to recognize an AB "submarket" within the ABC market. Indeed, it is precisely this line of reasoning that seems to have been followed in those cases advocating a submarket analysis.[47]

By providing some precision to the market definition process, the Guidelines' approach effectively avoids the confusion resulting from the submarket concept. First, because the Guidelines' market is, by definition, the *smallest* one in which a monopolist would find it profitable to raise prices, there is no need to look at any *sub*market. In addition, by standardizing the market definition test to a 5% price increase by a putative monopolist, the Guide-

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[47] *See, e.g., In re* IBM Peripheral EDP Devices Antitrust Litigation, 481 F. Supp. 965, 976 (N.D. Cal. 1979) ("Within a market, as defined by demand cross-elasticity considerations, economically significant submarkets may exist. Submarkets are zones of actual or potential competition that are sufficiently distinct from the larger market that one firm could exercise the power to control price or the power to exclude competition within them"); Liggett & Myers Co., 87 F.T.C. 1074 (1976) ("The *Brown Shoe* submarket criteria are designed for, and best adapted to, carving out narrow areas of more direct competition from wider areas of relatively less direct competition").

lines' approach provides some discipline to the market definition process, particularly where one is faced with a continuum of possible substitute products. Finally, the Guidelines' approach provides structure to the inferences drawn from market shares. This insures that "market power" means the same thing in different cases and allows any learning regarding the inferences to be drawn from high market shares to be applied consistently to all cases. Indeed, in the final analysis, the arguable "arbitrariness" of the Guidelines' 5% test, by imposing structure on the relationship between shares and the magnitude of the potential exercise of market power, is perhaps its greatest virtue.

The second possible justification for development of the submarket concept is that the courts may be attempting to deal with the problem of vulnerable consumers. This issue was first raised in the Supreme Court's decision in *United States v. Grinnell*.[48] In that case, the defendant, Grinnell, controlled three companies that offered hazard detecting devices installed on customer premises that transmitted a signal to a central station. The central station was manned 24 hours a day and dispatched the appropriate service (police, fire, etc.) in response to the signal.[49] Grinnell argued that their services competed with other noncentral station security systems like security guards, watch dogs and alarms.[50] The Court, though acknowledging that Grinnell faced some competition from such systems, nonetheless found that the relevant market must be smaller because "for many customers only central station protection will do." The "high degree of differentiation between central station protection and the other forms" was found sufficient to warrant treatment as a separate market.[51]

The same concept could be used to justify formation of a submarket. If some subset of customers appear particularly vulnerable, such as an identifiable group with fewer alternatives to the

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[48] 384 U.S. 563 (1966).

[49] *Id.* at 566–67.

[50] *Id.* at 574.

[51] *Id.*

product in question, then why not construct a submarket to address this issue? The problem is that the submarket analysis provides no guidance as to whether market power can effectively be exercised against this vulnerable group, or whether such "locked in" consumers are protected by the ability of less vulnerable consumers to switch to alternatives if prices were to increase.

Again, the Guidelines provide a logical construct for dealing with these issues. The Guidelines distinguish the protected consumers from the unprotected by asking whether firms can price discriminate to the vulnerable consumers, and allow for a smaller market only if price discrimination is possible.[52] That is, only if firms can raise prices to the vulnerable consumers without raising prices to the non-vulnerable consumers, will the vulnerable consumers constitute their own product market. This is the correct economic approach. If price discrimination is impossible, the firm cannot raise prices to the captive or vulnerable consumer without losing sales among noncaptive consumers. But if price discrimination is possible, then there will be no constraining force to protect these captive consumers.

B. *Coherent framework for supply-side considerations*

The Guidelines also provide a workable framework for incorporating supply-side considerations. As described above, while the courts have struggled with the place of supply elasticity in merger and monopolization cases, the Guidelines unambiguously incorporate supply elasticity into the analysis by including among the firms participating in the market those firms that constrain exercises of monopoly power because they *could* enter the market within 1 year.[53]

This approach is much more workable than that currently used by the courts, in which the *products* that the new supplier would

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[52] Guidelines § 1.12.

[53] As discussed above, the Guidelines consider firms that can incur sunk costs and participate in the market within 2 years to be "potential new entrants." *See* Guidelines § 3.0.

shift away from in order to supply the preferred product are included in the relevant market. The current judicial approach can result in seriously misleading findings. A simple example will illustrate the problem.

Suppose that in the *Columbia Steel* case, discussed above, all steel manufacturers can make plates. However, manufacture of shapes requires expensive additional machinery, and only certain steel manufacturers have made this investment. Assume also that steel buyers cannot substitute plates for shapes, and vice versa; that is, plates and shapes are not demand-side substitutes for each other. Since plates and shapes are not demand-side substitutes, they would not be included in the same product market if one defined the relevant market only from the consumers' perspective. But supply substitution must also be considered in the market definition exercise. If the price of plates were to rise, producers of shapes could simply switch to producing plates (by not using the additional equipment). This might lead the court to conclude that plates and shapes belong in the same product market, since a price increase in plates could be defeated by supply substitution of shape manufacturing capacity into plate manufacturing. However, if the price of shapes were to increase, plate manufacturers would be unable to respond by increasing production of shapes—they would not have the additional machinery to make shapes. Thus, under these circumstances, plate manufacturers could not effectively constrain an exercise of market power in shapes. The court should conclude that the relevant market does not include plates and shapes, because there is no supply substitution from plates to shapes. This leaves the court in the awkward position of requiring that the product market include plates and shapes when an exercise of market power in plates is at issue, but not when an exercise of market power in shapes is considered. It is easy to see how confusion can arise when, as is usually the case, the court simply concludes that "the relevant product market is X" without the additional necessary qualifying statements.

The Guidelines' approach avoids this confusion. Plates and shapes are in different product markets because they are not demand-side substitutes for each other. But the potential supply-

side substitution is not ignored; the ability of current shape manufacturers to shift to the production of plates is included in identifying the market participants and computing market shares. When one is considering a possible increase in the price of plates, all potential producers of plates are considered (including current manufacturers of shapes). When an increase in shape prices is at issue, only producers of shapes would be deemed to participate in the market.

IV. Limitations on application of the Merger Guidelines to monopolization cases

While the Merger Guidelines can provide needed analytical tools and clarity in nonmerger cases, they cannot be applied blindly. Important differences exist between merger and monopolization cases. However, understanding these differences, the Guidelines can continue to provide important insights to the federal judiciary. Two limitations are highlighted here: (1) finding the appropriate starting point, and (2) dealing with preexisting anticompetitive conditions.

A. Finding the appropriate starting point—the source of the claimed market power

Because the Merger Guidelines' market definition test was developed in the context of merger cases, the Guidelines understandably give no guidance to courts regarding where to commence the market definition exercise in nonmerger cases. In merger cases the starting point is clear: the concern is the creation of additional market power or anticompetitive potential resulting from a horizontal merger. Accordingly, the Guidelines properly direct an examination of the products supplied by the merging parties and an analysis of any market overlaps, for these are the only potential sources for exercises of market power resulting from the merger. The process is not so easy in monopolization cases, however, where the source of the alleged market power may be varied. In such cases, mechanical application of the Guidelines can lead to incorrect inferences.

So, how is the court to determine where to begin applying the Guidelines' hypothetical monopolist test? The answer lies in the nature of the plaintiff's antitrust claim. In a merger case, market power is alleged to result from the combination of the merging parties; hence, the examination begins with the products of the merging firms and their overlaps. In contrast, in a tying case, the defendant is accused of using its market power over a consumer-preferred product to force the consumer to also purchase a less favored additional product. For the plaintiff's theory to have any credence, the defendant must have power in the market for the allegedly consumer-preferred product. Hence, that is the legally relevant market, and that is where the analysis must begin.

A recent case involving suppliers of municipal wastewater treatment equipment, *United Industries v. Eimco Process Equipment Co.*,[54] is instructive. Some elementary background on municipal wastewater treatment is helpful to understanding the case. Since few municipalities have the expertise to design and evaluate wastewater treatment systems in-house, the standard practice for a municipality contemplating the construction of a wastewater treatment facility is to retain a professional consulting engineer to assist the municipality in choosing a particular system and developing a "facility plan." The engineer also prepares "specifications" for the project, detailing each item of equipment that will be used in the selected treatment system. The specifications are then "let out to bid" to general contractors who bid for the right to construct the system according to the specifications. Equipment suppliers likewise bid their particular pieces of equipment to the general contractor candidates for inclusion in the contractor's final bid to the municipality.

The defendant Eimco participated in the market both as a system supplier, offering a branded wastewater treatment system (sold under the tradename "Carrousel®") that competed with a large variety of other similar systems, and also supplying process

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[54] *See* Amended Ruling on Defendants' Motions for Summary Judgment on Lack of Standing and Lack of Market Power, slip op. (M.D. La., Jan. 27, 1994), *aff'd*, 61 F.3d 445 (5th Cir. 1995).

equipment capable of being used in Eimco and other designed systems. In contrast, the plaintiff United Industries only offered equipment, specifically aerators that could be used either in Eimco-designed systems or other systems. United's section 2 Sherman Act claim against Eimco alleged that Eimco's system specifications, provided to the consulting engineers in conjunction with Eimco's proposal for use of the Carrousel® system, disadvantaged United's aerator in ways that induced contractors to fail to include United's aerator in their bids, thereby resulting in damage to United and to the consuming municipalities (who allegedly paid higher prices for comparable or lower quality equipment).

United's retained economic expert, applying the Merger Guidelines' test, defined the relevant market as aerators for use in Carrousel-type systems. Strictly following the Guidelines as if this were a case analyzing a merger between Eimco and United, the expert identified aeration equipment for Carrousel-type systems as the "relevant market" because it was the market in which both United and Eimco supplied products—i.e., it was the location of the product overlaps. Applying the 5% test and the smallest market principle, United asserted that one could raise the price of such aerators 5% without inducing switching to other types of aerators because the other aerators would not satisfy the Carrousel® system specifications. United's proffered relevant market had its intended result. Sales information showed that Eimco, through its equipment division, sold 90% of the aerators used in Carrousel® systems. Based on this information, United claimed it had amply satisfied the market power element of its section 2 case.

Nonetheless, the court entered summary judgment for Eimco finding, among other things, a failure of proof on the market power element. Where did United go wrong? After all, it faithfully followed the Guidelines. The problem was that United's market definition analysis did not comport with its legal theory, or, as the district court articulated it, "[t]he affidavit of United's expert in economics did not define the markets key to United's claim."[55]

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[55] *Supra* note 54, slip op. at 2.

Under United's theory, Eimco's large percentage of aerator sales into Carrousel® systems resulted from the allegedly discriminatory specifications adopted by the municipality and its consulting engineer at the time they selected the Carrousel® system over competing wastewater treatment system alternatives. But why would the municipality and the professional consulting engineer agree to restrictive specifications which allegedly had the effect of increasing the aerator price paid by the municipality? United's answer to this question proved to be the death-knell to its case. United claimed that the municipality was *forced* to accept Eimco's specifications as a condition to obtaining the Carrousel® system. But such compulsion could only be effective if the municipalities could not shift to other wastewater treatment system alternatives. Thus, United had to prove that Eimco had market power in the wastewater treatment systems market—that Eimco's Carrousel® system had significant competitive advantages over other wastewater treatment systems. This United could not do.

United and its expert had applied the Merger Guidelines' market definition test at the wrong place. While the smaller aerator equipment market—the area of overlap between the products offered by United and Eimco—would undoubtedly have been the appropriate starting point for analyzing a proposed merger between United and Eimco, it manifestly was not the proper starting point for analyzing United's leveraging claim. United's antitrust case was premised on a leveraging theory, yet it had not undertaken to prove market power in the leveraging market.

Importantly, the defect was not in the Guidelines' test, but in its application. In merger cases, it is the joining together of the two previously independent entities that produces the potential for anticompetitive effects. In nonmerger cases, it is something else; and that something else depends on the plaintiff's theory of the case. This does not mean, however, that the Guidelines' market test and method for computing shares in that market are useless in nonmerger cases. Quite the contrary. Once the proper starting point is identified, the analytical constructs work equally well in nonmerger cases. Indeed, it was just such an analysis in the *United Industries* case that proved that there was no separate

market for Carrousel-type systems (i.e., that a hypothetical monopolist of such systems could not profitably increase the price above 5%), but rather that the relevant market must include alternative wastewater treatment systems.

B. Dealing with preexisting anticompetitive conditions— the problem of noncompetitive prices

Another frequent problem affecting market definition in antitrust cases arises from dealing with the effects of preexisting anticompetitive conditions—the so-called Cellophane Trap. This is not a problem unique to use of the Guidelines' market definition test, but rather is a problem faced by all market definition methods. For obvious reasons, the scope and contour of the relevant market is highly sensitive to the baseline prices that are used when attempting to define the market. The demand for any product becomes more elastic as price increases. If the baseline price used in the analysis is higher than the competitive price, the number of substitutes and therefore the size of the market will be exaggerated.

This problem was critical to the Supreme Court's *Cellophane* decision.[56] That case involved a determination of whether cellophane constituted a separate product market, or whether other flexible wrapping materials were "reasonabl[y] interchangeab[le] for the purposes for which they are produced."[57] Applying the reasonable interchangeability test at the then prevailing prices of cellophane and of the proffered alternative flexible wrapping materials, the district court found the other products to be reasonable substitutes for cellophane and included them in the market. What the court apparently failed to recognize, however, was that the price at which a product is offered has a significant effect on what products are reasonably interchangeable, and that, to be most instructive, the reasonable interchangeability test should reflect

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[56] United States v. E.I. du Pont de Nemours & Co., 351 U.S. 377 (1956).

[57] *Id.* at 404.

what products are feasible alternatives at near competitive prices (e.g., to borrow a threshold from the Guidelines, 5% over the competitive price). Accepting the current price as the appropriate baseline price for analyzing the market significantly skewed the court's analysis. At then current prices, cellophane was indeed interchangeable with other flexible wrapping materials. However, this was only because cellophane was already being sold at a monopoly price.

The Guidelines' test can likewise render misleading results if adjustments are not made for preexisting anticompetitive conditions. Indeed, because the Guidelines directly concern themselves only with the additional potential for *future* exercises of market power resulting from a merger and do not address preexisting monopoly conditions,[58] the Guidelines are understandably ill-suited to address such issues.[59] A court adopting the Guidelines' market test in a monopolization case must therefore be particularly wary. Noncompetitive existing prices are much more likely to arise in monopolization cases. Indeed, existing exercises of market power are the central focus of such cases.

The courts, however, are not left without any guidance on this issue. An early opinion by Judge Learned Hand, *United States v. Corn Products Refining*,[60] provides an outline for evaluating the competitiveness of prevailing market prices and adjusting for above competitive prices in the market definition process.

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[58] *See* W. Baxter, *Responding to the Reaction: The Draftsman's View*, 71 Cal. L. Rev. 617 (1983); R. Posner, Antitrust Law, An Economic Perspective 128 (1976).

[59] In practice, the enforcement agencies consider evidence of present or past collusion in the market as increasing the likelihood of coordinated activity following the merger and may challenge such a merger if the market is concentrated. *See* Guidelines § 2.1. Thus, the problem of noncompetitive current prices is addressed to some extent in the Guidelines. However, at several places, the Guidelines specifically refer to price increases "above competitive levels." *Id.* at 0.1.

[60] 234 F. 964 (S.D.N.Y. 1916).

Corn Products was a Sherman Act case alleging monopolization of the corn starch and corn syrup markets. Attempting to diminish their undeniably large market share in corn starch and corn syrup, the defendants advanced a broader relevant market definition, including several functional substitutes for corn starch, such as potato and wheat starches, sago, tapioca and grits, as well as several substitutes for corn syrup.[61] Judge Hand was not persuaded. While acknowledging that such products "compete" with corn starch and corn syrup in the broadest sense of the word, Judge Hand nonetheless concluded that they provided no significant constraints on the defendants' ability to exercise market power because of the significant cost advantages enjoyed by corn starch and corn syrup. While the substitutes constrained prices at some level, they still left a significant area for the exercise of market power unprotected.[62]

This is the right economic result. By focusing on the fact that the substitutes for corn starch at the then prevailing prices all had materially higher costs of production, Judge Hand was able to discern that corn starch was already selling at above competitive prices (i.e., at higher price-cost margins), and therefore should constitute its own product market. This same approach could have been used to avoid the Cellophane Trap in the case that gave it birth. Instead of merely accepting the current prices as the appropriate baseline, the *Cellophane* court could have compared the production cost of cellophane to the alternative flexible wrapping products and determined that they belonged in separate markets.

The *Corn Products* approach provides an appropriate paradigm for courts faced with preexisting noncompetitive prices. A current example in which the problem of noncompetitive prices is a major difficulty involves the vertical integration of multiprovider networks in the health care industry. Such cases typically involve hospitals acquiring physician groups, insurers acquiring providers,

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[61] *Id.* at 975.

[62] *Id.* at 976 ("The most that can be said of [the substitutes] is that they do afford a substantial limit upon the wet millers' [corn starch] price, because they come in if it got high enough").

or drug manufacturers acquiring drug resellers. In such situations, the antitrust enforcement agencies have focused on the creation of entry barriers as the source of competitive harm potentially resulting from such integration.[63]

Critical to evaluating whether such barriers will harm competition is ascertaining the proper relevant market, and particularly the relevant geographic market, in which such alleged entry barri-

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[63] *See* Statements of Enforcement Policy and Analytical Principles Relating to Health Care and Antitrust, U.S. Department of Justice and Federal Trade Commission (Sept. 27, 1994), No. 9. ("A key concern for the agencies in analyzing the vertical aspects of a network is the extent to which the network's arrangements with its provider members will foreclose competition by impeding the formation and operation of competing networks.") *See also* 1984 Non-Horizontal Merger Guidelines at ¶ 4, 21 ("the vertical integration resulting from vertical mergers could create competitively objectionable barriers to entry").

Under the 1984 Non-Horizontal Merger Guidelines' approach, vertical mergers that require a new entrant to enter two markets simultaneously to successfully compete, and where such entry is "less likely," are condemned as anticompetitive. *See also* Mary Lou Steptoe, Director of the Bureau of Competition, Federal Trade Commission, *FTC Vertical Enforcement: What's New in RPM and Vertical Mergers*, Remarks Before the ABA Section of Antitrust Law (Nov. 4, 1994) ("If such 'two-level' entry is more risky, more difficult, or more time consuming than entry into the primary market alone, a merger that increases vertical integration could create objectionable barriers to entry"); Christine A. Varney, Commissioner, Federal Trade Commission, Remarks Before the Health Care Antitrust Forum (May 2, 1995) ("An industry can become so highly vertically integrated that 'two-level' entry becomes necessary to enter *both* markets. If such two-level entry is more risky, difficult or time consuming than entry into one of the markets alone, a merger that increases vertical integration could increase barriers to entry and thus be anticompetitive").

A similar approach has been adopted by courts faced with vertical merger situations. *See, e.g.*, Ford Motor Co. v. U.S., 405 U.S. 562 (1972) (striking down Ford's acquisition of a spark plug manufacturer on the theory that the acquisition would raise a "barrier to entry"); Fruehauf Corp. v. F.T.C., 603 F.2d 345 (2d Cir. 1979) (The primary factor in analyzing a vertical merger is "the degree, if any, to which it may increase barriers to entry into [a] market or reduce competition").

ers will operate. For example, in the hospital provider situation, whether new barriers to entry will impact the competitive performance of the hospital market hinges on the geographical confines of the hospital market and its present structure. The Elzinga-Hogarty (E-H) test[64] is frequently used for determining the relevant geographical hospital market. The E-H test attempts to determine market boundaries through an analysis of historical patient flow patterns. Two criteria are used: (1) the percent of local patients using the local hospital or hospitals as a percent of total local hospital patients (LOFI), and (2) the volume of non-local patients using the local hospital as a percent of total local patients (LIFO). If both LOFI and LIFO are above 90% the area will generally be considered a relevant market.[65]

But the existence of already noncompetitive prices can dramatically affect the results of the E-H test. Because of preexisting above-competitive prices, patients and payors may already be seeking alternatives that they would not seek if competitive prices prevailed. Thus, an acute-care hospital market may not run afoul of the E-H test precisely because it is already performing noncompetitively. Moreover, using the Guidelines' approach would only exacerbate the problem. Asking what the E-H pattern would look like if prices were increased by 5% would make the market appear even larger and disguise even further the lack of competitive performance in the true underlying relevant market.

Again, the *Corn Products* approach offers some guidance. The court or enforcement agency cannot apply the E-H test uncritically. It must first analyze the price charged by the local hospital and determine whether its price-cost margins are in line with those obtained in known competitive markets. Higher than normal margins would be indicative of existing monopoly power and may justify finding a smaller geographic market.

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[64] *See* Elzinga & Hogarty, *The Problem of Geographic Market Delineation in Antitrust Suits*, 18 ANTITRUST BULL. 45 (1973).

[65] *See* Eisenstadt, *Health Care Antitrust Analysis: Thinking Through the Economic Issues*, *in* ANTITRUST HEALTH CARE ENFORCEMENT AND ANALYSIS 102 (1992).

V. Conclusion

For decades, courts have been struggling to find a coherent and workable method for defining relevant markets in antitrust cases. The market definition test contained in the 1992 Merger Guidelines seems to fit the bill. It provides a single standard (the 5% test) for determining which substitutes are "close enough" to be included in the market and, thereby, provides direction to courts and consistency among cases. It also provides a coherent framework for dealing with the issue of vulnerable consumers and incorporating supply-side considerations without unduly complicating the process by trying to do too many things at once.

The Guidelines' test cannot be imported wholesale into nonmerger cases without some critical thought, however. There are important differences between merger and nonmerger cases. If these differences are kept in mind and appropriate adjustments are made, particularly in the areas of ascertaining the appropriate starting point and adjusting for preexisting noncompetitive conditions, the Merger Guidelines' test can bring much needed analytical rigor and consistency to the market definition process in all antitrust cases.