

# Antitrust Insights


 Spring 2009

## From the Editor

The analysis of the competitive effects of a proposed transaction is a *forward-looking* exercise in which the focus is on whether the transaction will lead to higher prices in the future. However, to make this determination, the analysis often rests on a backward look at the extent to which the merging parties were competitors prior to the transaction. Historical data on pre-transaction competition are important, but do they tell the whole story?

In this issue of *Antitrust Insights*, Timothy Daniel discusses four proposed mergers that were challenged by the Federal Trade Commission in 2007 and 2008. Although all four case studies highlight the importance of analyzing data on the degree to which the merging parties have been competitors, they also show that such evidence is not sufficient to assess the state of competition that would result with and without the transaction. As Tim describes below, information on the merging parties' future competitive plans, the potential for the transaction to generate efficiencies, the competitive responses of rivals, and the future competitive viability of the firm being acquired are important considerations that cannot be ignored.

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I hope you enjoy this issue. Please feel free to circulate this to your colleagues. And if you have comments or suggestions, please let me know. Your views are always welcome.

—Lawrence Wu, Editor

## Merger Analysis and the Importance of Looking Beyond the Level of Pre-Transaction Competition Between the Merging Parties

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Timothy Daniel

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Whether a proposed transaction is likely to harm competition depends in large part on the degree to which the merging parties are likely to be strong competitors if there were no transaction. If the rivalry between the merging parties is expected to be robust if the entities remained independent, then the proposed transaction could well eliminate an important source of supply and competitive vigor in the market. However, the level of premerger competition between the merging parties need not be a good predictor of the transaction's likely competitive effects. A number of factors in addition to direct competition between the merging parties can affect whether the proposed transaction might reduce competition.<sup>1</sup> A careful assessment of these additional factors is needed to assess how the relevant markets are likely to perform with and without the proposed transaction.

To assess whether a proposed transaction is likely to harm consumers by eliminating an important source of competitive rivalry in the market, merger analysis typically begins by examining the degree to which the merging parties were strong competitors prior to the announcement of the merger. While straightforward and potentially central to the competitive analysis, this analysis is not sufficient. As I discuss below, data on



premerger competition between the merging parties do not tell the whole story. To highlight the issues and to explain why, I will discuss four transactions that were challenged by the US Federal Trade Commission (FTC) in 2007 and 2008. I begin with an analysis of a transaction involving Western Refining, Inc. (Western) and Giant Industries, Inc. (Giant), two suppliers of light petroleum products. I then discuss an acquisition involving Equitable Resources, Inc. (Equitable) and Dominion Resources, Inc. (Dominion), which distribute natural gas in and around Pittsburgh, Pennsylvania. Next, I discuss a proposed transaction between CCC Information Services, Inc. (CCC) and Mitchell International, Inc. (Mitchell), suppliers of software to insurance firms and automobile repair shops. My last example is a transaction involving two hospitals in Northern Virginia, Inova Health System Foundation (Inova) and Prince William Health System, Inc. (PWHS).

### Accounting for Pre-Transaction Plans to Expand Output

In the case of Western's proposed acquisition of Giant, the FTC alleged that the transaction likely would reduce competition in the market for the bulk supply of light petroleum products into northern New Mexico.<sup>2</sup> Following a hearing, the District Court denied the FTC's request for a preliminary injunction, after which the FTC decided (in a 3-2 vote) to dismiss its administrative complaint, thereby ending the FTC's investigation. The District Court's opinion and statements by the Commission (explaining the decision to dismiss the administrative complaint) and certain Commissioners (dissenting from that decision) highlight the fact-intensive nature of the competitive analysis in this transaction.<sup>3</sup>

In the Western/Giant matter, the analysis focused on how the relevant market would perform with and without the transaction. These assessments were necessarily affected by the decision of one of the merging parties, Giant, to undertake investments unrelated to the merger to increase the amount of refined product produced by its two refineries located in northwestern New Mexico. As a result, the FTC was concerned that the historical competitive interaction between the parties in the relevant market was not reflective of the extent to which the merging parties would have competed but for the transaction.<sup>4</sup>

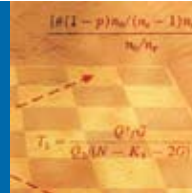
Although Giant's additional production capacity could potentially provide additional supply to the northern New Mexico market, historical production and shipment data could not shed direct light on this question because the additional capacity had not yet been brought on line. The FTC believed that it was likely that Giant would deliver "substantially more gasoline to the Albuquerque/Santa Fe area" after its additional production became available.<sup>5</sup> Regardless of the magnitude of Giant's additional shipments into northern New Mexico from its refineries, any additional output would, *ceteris paribus*, put downward pressure on prices and profit margins, which would in turn induce Giant and rival suppliers to revise their decisions regarding how much output to transport to the northern New Mexico market from other sources. Predicting how the merger might affect the quantity of refined product shipped into northern New Mexico by the merging parties and their rivals, relative to what they would have done absent the merger, is a separate question.

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The key issue, therefore, was whether the ultimate supply of refined product into northern New Mexico would be lower as a result of the merger, taking into account the increased production at Giant's New Mexico refineries and the merging parties' and their rivals' responses to this change. The answer to this question depends on the merging parties' incentives, as well as rivals' potential supply responses, which in turn depend on their opportunity costs of selling products into northern New Mexico.

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The District Court concluded that the level of output available in northern New Mexico was not likely to be affected by the merger, in part because it was not persuaded by the FTC's economic expert's attempts to model the market outcomes that would likely arise with and without the transaction, taking into account Giant's increased production. In light of this finding, and other evidence, the District Court concluded that the FTC had not demonstrated that the transaction was likely to harm competition substantially in a relevant antitrust market.

The key economic point is that merging parties need to model carefully and persuasively the two future states of the world relevant to merger analysis: the market with the merger, and the market “but for” the merger, taking into account any changes from the pre-transaction environment not related to the merger itself, such as capacity increases. In this case, Giant's expansion plans, which were independent of the merger, could have caused the competitive interactions among the suppliers in the relevant market prior to the transaction to be different from those that likely would have occurred if the transaction were blocked.

### **Assessing Merger-Related Efficiencies is Fact Intensive, Even in “Natural Monopoly” Industries**

In March 2007, the FTC issued an administrative complaint challenging the transaction between Equitable and Dominion, alleging that the transaction would substantially reduce competition for the distribution of natural gas in and around Pittsburgh, Pennsylvania.<sup>6</sup> From the beginning, the FTC's investigation raised an important legal issue: did the FTC have jurisdiction over a transaction that was also subject to review by the Pennsylvania Public Utility Commission (PAPUC)? In May 2007, a District Court ruled that the FTC did not have jurisdiction on state action grounds.<sup>7</sup> The FTC appealed that ruling and obtained an injunction pending appeal from the Appeals Court.<sup>8</sup> Prior to the completion of the appeal process, the parties abandoned the transaction in January 2008, thereby terminating the FTC's investigation.

Lurking behind this critical jurisdictional issue were several interesting economic questions, the most obvious being the following: given the natural monopoly characteristics of natural gas distribution, why did Equitable and Dominion compete at all, how did the competition come to happen, and was the competition worth preserving? Natural gas distribution is typically a textbook example of a natural monopoly, where the costs of providing distribution services to a given set of customers are minimized when only one firm incurs the costs of developing a distribution network. It would seem, therefore, that the combination of the two largest (and overlapping) natural gas distribution networks in and around Pittsburgh would exploit these natural monopoly characteristics, reduce the costs of supplying natural gas distribution services to customers, and improve consumer welfare.

Notwithstanding these plausible natural monopoly arguments, the merging firms had competed for many years for commercial and industrial customers. As a result of Pittsburgh's historic role as a major steel producer, several independent, natural gas distribution systems were constructed in and around Pittsburgh to



serve the area's commercial and industrial customers. Over time, these independent distribution networks expanded, ultimately coming close enough to each other to compete for some of the region's commercial and industrial natural gas customers. While the maximum rates charged to these customers were regulated by the PAPUC, price competition for certain commercial and industrial customers occurred in the form of discounts below posted tariff rates.<sup>9</sup> This was the pre-transaction competition that the FTC wished to preserve.

The key economic question, therefore, was whether the consumer benefits that would result by preserving the level of pre-transaction competition were large enough to outweigh the consumer benefits from the potential cost savings that the firms could implement if they were allowed to combine. The merging parties' claim was that the merger would allow the two firms to combine into an efficient natural monopoly, thereby reducing the costs of maintaining and upgrading an integrated natural gas distribution system.<sup>10</sup> The FTC's claim was that the parties were the only providers of natural gas distribution services to certain customers, and that, if the merger were blocked, commercial and industrial consumers in and around Pittsburgh would continue to benefit from the ongoing competition between the two firms.<sup>11</sup>

The evidence on pre-transaction pricing was informative because it illustrated the rivalry that had developed between Equitable and Dominion. But the analysis had to go further because of the possibility that, if the transaction were allowed, prices could fall if the cost savings and other efficiencies outweighed the price

increase that likely would result if the merging firms no longer competed. Indeed, the merging parties contended that the potential for price increases for a relatively small number of commercial and industrial customers would have been overwhelmed by the cost savings from combining their systems into a single natural monopoly provider. These savings could have reduced prices for a significantly larger number of residential customers.<sup>12</sup>

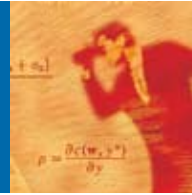
The parties' natural monopoly argument makes logical sense. If one accepts the textbook argument that natural gas distribution is a natural monopoly, then the competition between the two firms was in some sense an historical accident and their combination would allow for significant merger-specific cost reductions. But noting that natural gas distribution is typically a natural monopoly does not establish that it actually is one in Pittsburgh, where multiple natural gas distribution firms have operated for decades. Combining existing, independent systems into a single unified system in the hilly, rocky terrain in and around Pittsburgh could have been a complex and costly undertaking.

In the end, therefore, whether the distribution of natural gas in and around Pittsburgh is a natural monopoly is an empirical issue, not a conceptual one. In the case of Equitable and Dominion, the FTC's decision to challenge the transaction indicates that it concluded that the natural monopoly efficiencies were not sufficiently persuasive to outweigh the price increases that were all but certain to occur were the merger to be approved. In this case, the assessment of the relevant market with and without the transaction required a detailed analysis of

## About NERA

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the potential for efficiencies from combining two firms that had operated independently and competed directly for many years. This analysis required an assessment of not only pre-transaction pricing, but also the likely cost savings that would result from the transaction. Thus, focusing on the pre-transaction competition between the parties, while important, was not sufficient.

### **Assessing the Potential for Unilateral Price Effects in Concentrated Markets**

In November 2008, the FTC issued a complaint and sought a preliminary injunction to block the merger of CCC and Mitchell, two of the three leading suppliers of specialized software to insurance companies and automobile repair shops. The software was used by these customers to develop estimates for the cost of repairs and to develop values for vehicles involved in accidents.<sup>13</sup> The FTC argued that in this concentrated market, the merger was unlawful under both unilateral and coordinated theories of competitive harm.<sup>14</sup> In March 2009, after a one-week hearing, the District Court in March 2009 granted the FTC's request for a preliminary injunction, and the parties decided to abandon the transaction a few days later.<sup>15</sup>

The District Court opinion granting the FTC's motion for a preliminary injunction accepted the FTC's contention that the transaction was likely to increase the likelihood of anticompetitive coordination between the merged firm and its lone remaining significant rival. However, the District Court did not agree with the FTC that the transaction was likely to result in unilateral price effects. This is a notable ruling because, prior to the transaction, the relevant market had only three significant competitors. Notwithstanding some evidence of direct

pre-transaction competition between the merging parties, the District Court concluded that the FTC did not establish one critical element of a unilateral effects theory of harm: that the remaining competitor(s) in the market would be unable to replace the competition that would be lost if the target firm were acquired.

The models regularly applied by economists to assess unilateral effects in differentiated products markets often predict that transactions with far lower shares and far more competitors than present in the CCC/Mitchell matter likely would lead to higher prices.<sup>16</sup> That a merger of two firms among three would not risk anticompetitive unilateral effects is, at first glance, a rather remarkable result.

In this case, the explanation for the District Court's finding regarding the potential for unilateral effects rested on facts that described how "these markets operate in fact."<sup>17</sup> In examining the competitive dynamics in the relevant markets, the District Court concluded that sellers typically bid for a buyer's business, and that buyers and sellers typically negotiate over the terms of the final transaction. When buyers and sellers meet each other in such settings, competitive pricing can arise with relatively few sellers even if customers buy somewhat differentiated products or bundles of products. In fact, the District Court concluded that the relevant product markets were "highly competitive" prior to the transaction notwithstanding the concentrated supplier base.<sup>18</sup>

In general, when three (or a few) qualified suppliers compete in a bidding environment, the unilateral effects question becomes the following: will the combination of two of the suppliers in the market hamper significantly

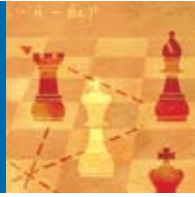
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a customer's ability to obtain competitive pricing? The answer to this question depends on the competitive strength and capacity of the remaining firm(s) in the market, and whether they are viewed by a significant number of customers as producing products inferior to the products supplied by the merging parties. In its analysis of the CCC/Mitchell transaction, the District Court concluded that the FTC did not produce persuasive evidence on this point, and thus found that the transaction did not pose a risk of unilateral effects.

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**Even if there is evidence of significant pre-transaction competition between the merging parties, whether prices are likely to rise as a result of a transaction will depend on a host of other factors, including the ways in which buyers and sellers interact in the marketplace and the ability of any remaining competitor(s) in the market to quickly and effectively expand or reposition themselves to maintain the level of competition that existed prior to the merger.**

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The CCC/Mitchell decision demonstrates the importance of applying the proper economic framework to the competitive analysis. A transaction involving firms with relatively high shares in a highly concentrated market may not pose unilateral competitive concerns if the transaction will not impede customers from continuing to obtain competitive pricing. In other words, even if there is evidence of significant pre-transaction competition between the merging parties, whether prices are likely to rise as a result of a transaction will depend on a host of other factors, including the ways in which buyers and sellers interact in the marketplace and the ability of any remaining competitor(s) in the market to quickly and effectively expand or reposition themselves to maintain the level of competition that existed prior to the merger.

#### **Assessing the Future Competitive Significance and Viability of the Firm Being Acquired**

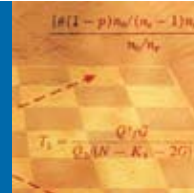
In May 2008, the FTC issued an administrative complaint alleging that the proposed merger between Inova and PWHS would be anticompetitive.<sup>19</sup> The FTC sought to obtain a preliminary injunction that would have enjoined the parties from closing the transaction prior to the completion of an administrative proceeding to determine the transaction's likely effect on competition. Several weeks after the issuance of the complaint, the parties decided to abandon the transaction, thereby ending the FTC's investigation.

## **Our Practice**

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NERA economists employ economic theory and quantitative methods grounded in a thorough understanding of the market facts to provide a full range of theoretical and empirical economic analysis and testimony in matters involving mergers and acquisitions, antitrust litigation, and competition policy. We advise companies and their attorneys, as well as governments and regulators, throughout the world on investigations of alleged monopolization, abuse of dominant position, and market power. We analyze the entire range

of economic issues that arise in antitrust cases, including market definition and market power, market structure and entry conditions, pricing, and other conduct affecting competition, profitability, and damages. NERA's expertise includes assessing and, when necessary, testifying to the economic merits of allegations of foreclosure and exclusionary conduct, tying and bundling, refusals to deal, vertical restraints, collusive behavior, essential facilities, and anticompetitive pricing behavior.



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## Evidence of pre-transaction competition is useful, but it may not tell the whole story.

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The FTC has a long history of investigating hospital mergers, and this transaction raised a number of interesting issues. According to the FTC, the transaction would have combined firms of very different sizes and geographical footprints. Inova, with five hospitals and nearly 1,900 acute care beds, is the largest hospital system in Northern Virginia by a sizable margin. PWHS, by contrast, operated just one hospital with 170 acute care beds. As stated in the Complaint that it filed in District Court, the FTC claimed that it had developed evidence and obtained testimony from health insurers that the two hospitals directly competed with one another in both price and nonprice dimensions.<sup>20</sup> The FTC thus concluded that the transaction threatened to eliminate the beneficial outcomes fostered by this competition.

Such evidence of pre-transaction competition is useful, but it may not tell the whole story and, as a result, the nature of pre-transaction competition between the parties may not be a good predictor of competition between them should the transaction not occur. In this case, the merging parties contended that Inova's more significant resources would result in significant additional investment in PWHS's hospital assets, and thus enhance the short- and long-term competitive vigor of PWHS.<sup>21</sup> Consumers of hospital services, as a result, would be better off if the merger were consummated compared to the "but for" world in which the smaller PWHS remained independent from Inova.

The issue of the competitive viability of one of the parties to a transaction has become more prevalent due to the economic downturn and the financial distress experienced by many firms, including those involved in mergers. Some of the factors that would enter the analysis include the firm's profitability going forward,

the firm's ability to make the capital investments to remain competitive going forward, and the availability of financing given the firm's financial condition. Evidence on pre-transaction capital investment and quality improvement projects by the firm to be acquired is an important part of the analysis, but only if they capture the firm's ability to do so in the future independent of the transaction.

At times, merger review can focus too narrowly on the profitability of short-term price increases to the neglect of the transaction's likely impacts on longer-term investment decisions, which affect competition and consumers over a longer horizon. It is important that merger review consider carefully the competitive strength of the parties over the long term, and the likely impact of the merger on the firms' abilities and incentives to invest and remain competitively strong.<sup>22</sup> As in the other cases discussed above, the Inova/PWHS transaction illustrates the importance of conducting a careful assessment of the likely state of competition that would result with and without the transaction and the need to conduct an inquiry that considers facts that go beyond the extent to which the merging parties competed prior to the transaction.

### Conclusion

Analyses of pre-transaction data are useful in merger review, but these data tell only part of the story. Such data are particularly useful for evaluating the degree to which the merging parties may have been close competitors historically. However, there are other considerations, and the case studies described above illustrate four important concepts. First, data on pre-transaction information may not fully capture the merging parties' future competitive plans and investments. If there are such plans, the extent of competitive rivalry pre-merger may provide a misleading view of the likely competitive effect of the transaction. Second, data on pre-transaction pricing may not capture the efficiencies and other cost savings that could lead to lower prices after the transaction. If there are such

efficiencies, they must be accounted for in the analysis. Third, pre-transaction rivalry between the merging firms need not lead to anticompetitive unilateral effects, even in highly concentrated markets, when buyers and sellers meet in a bidding environment and the non-merging rivals can quickly replace any competition lost by the merger. Finally, information on the target firm's pre-transaction competitive significance and viability may not be a useful indicator of that firm's ability to compete in the future. This is particularly important in times of financial distress and uncertainty. There is no question that pre-transaction data are useful sources of information, but as the cases above illustrate, merger analysis typically requires much more.

## NOTES

- 1 These factors include the number and strength of the other competitors in the market, the ease with which competitors could expand their output, the potential for repositioning by competitors, barriers to entry (or the lack thereof), and cost savings and other efficiencies.
- 2 See Complaint for Temporary Restraining Order and Preliminary Injunction Pursuant to Section 13(b) of the Federal Trade Commission Act, *FTC v. Paul L. Foster et al.*, Civil Action No. 07cv352 JH/ACT (12 April 2007), available at <http://www2.ftc.gov/os/caselist/0610259/070412western-giantcmplt.pdf>.
- 3 See *Federal Trade Commission v. Paul L. Foster et al.*, 2007 WL 1793441 (D.N.M.) (District Court Opinion denying the FTC's request for a temporary restraining order and preliminary injunction). See also Statement of the Commission Concerning the Dismissal of the Administrative Complaint (3 October 2007) and Dissenting Statement of Commissioner Pamela Jones Harbour and Commissioner J. Thomas Rosch (3 October 2007).
- 4 See Plaintiff's Memorandum of Points and Authorities in Support of Motions for Temporary Restraining Order and Preliminary Injunction, *Federal Trade Commission v. Paul L. Foster et al.*, Case No. 1:07-cv-00352-JB-ACT (19 April 2007) at page 1, available at <http://www2.ftc.gov/os/caselist/0610259/070417ccmemoptsandauth.pdf>.
- 5 See Administrative Complaint in *Federal Trade Commission v. Paul L. Foster, et al.*, Docket No. 9323 (3 May 2007) at ¶34.
- 6 See Complaint *In the Matter of Equitable Resources et al.*, Docket No. 9322 (14 March 2007), available at <http://www2.ftc.gov/os/adjpro/d9322/0703admincmp.pdf>.
- 7 *FTC v. Equitable Resources et al.*, No. 07cv0490 (Mem. Op.) (14 May 2007).
- 8 *FTC v. Equitable Resources et al.*, W.D. Pa No. 07-cv-00490 (21 May 2007).
- 9 See Complaint *In the Matter of Equitable Resources et al.*, Docket No. 9322 (14 March 2007) at ¶23, available at <http://www2.ftc.gov/os/adjpro/d9322/0703admincmp.pdf>.
- 10 The merging parties developed these arguments during the review of the transaction by the PAPUC. See, for instance, Prepared Rebuttal Testimony of William H. Hieronymus, PAPUC Docket No. A-12250F5000 (September 2006).
- 11 See Complaint *In the Matter of Equitable Resources et al.*, Docket No. 9322 (14 March 2007) at ¶¶28-29, available at <http://www2.ftc.gov/os/adjpro/d9322/0703admincmp.pdf>.

- 12 See "Equitable Resources Contesting FTC Action That Will Delay Savings to Consumers, Remains Committed to Dominion Acquisition," Equitable Resources Press Release (15 March 2007).
- 13 See Complaint *In the Matter of CCC Holdings Inc. et al.* (25 November 2008), available at <http://www2.ftc.gov/os/adjpro/d9334/081125cccmitcheadmincmpt.pdf>.
- 14 Under a unilateral theory, the merged firm has the incentive and ability to raise prices post-transaction regardless of the responses of its rivals. Under a coordinated theory, the merged firm can raise prices only if it can effectively act in concert with its rivals post-transaction.
- 15 *FTC v. CCC Holdings, Inc. et al.*, No. 08-2043 RMC (Mem. Op.) (18 March 2009).
- 16 See, for instance, the models discussed in Joseph Farrell and Carl Shapiro, "Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition," Preliminary Draft (2 November 2008). In this paper, Farrell and Shapiro develop an analysis demonstrating that transactions likely to exert upward pressure on prices can be identified by examining the parties' variable margins and the diversion ratio between the products sold by the two firms. In a market with only three significant competitors, the diversion ratio between any two of them would almost certainly be sufficient to satisfy the Farrell and Shapiro test for the presence of upward pricing pressure should two of the rivals propose to merge.
- 17 *FTC v. CCC Holdings, Inc. et al.*, No. 08-2043 RMC (Mem. Op.) (18 March 2009) at p. 30.
- 18 *Id.* at pp. 9-10.
- 19 *Federal Trade Commission and Commonwealth of Virginia v. Inova Health System Foundation and Prince William Health System*, Complaint for Preliminary Injunction, (12 May 2008).
- 20 *Id.* at ¶40.
- 21 See "Statement of Inova Health System Regarding the Initial FTC Merger Challenge," Inova Press Release (9 May 2008), available at [http://newsroom.inova.org/article\\_display.cfm?article\\_id=5139](http://newsroom.inova.org/article_display.cfm?article_id=5139).
- 22 For a discussion of the need for merger review to assess a transaction's likely effect on the firms' ability and incentives to invest, and an explanation for why a merger may enhance the likelihood that consumer-welfare enhancing investments will occur, see Ramsey Shehadeh, Joseph Larson, and Ilene Knable Gotts, "The Effect of Financial Distress on Business Investment: Implications for Merger Reviews," *Antitrust*, pp. 12-17 (Spring 2009).

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