IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA, et al., *Plaintiffs*, v. FIRST DATA CORPORATION, and CONCORD EFS, INC., *Defendants*.	CASE NUMBER: 1:03CV02169 (RMC) **REDACTED VERSION**

PLAINTIFF UNITED STATES' REPLY TO DEFENDANTS' PRETRIAL BRIEF

I. The Hypothetical Monopolist Test Is *The* Standard Market Definition Test

Defendants suggest that the hypothetical monopolist test (HMT) was concocted by the federal enforcement agencies and has been applied by few courts. It is, however, widely acknowledged to be the standard test, with roots in Supreme Court precedent. The HMT stems from the insight that market shares are useful predictors only if a 100 percent share would confer significant market power, as observed in the seminal *Cellophane* decision.[1] The HMT clarifies and implements, rather than contradicts, *Cellophane*'s teaching that the relevant market "is composed of products that have reasonable interchangeability for the purposes for which they are produced—price, use and qualities considered." 351 U.S. at 404. Even before the 1982 Merger

[1] *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391-92 (1956) ("If cellophane is the 'market' that du Pont is found to dominate, it may be assumed it does have monopoly power over that 'market.' . . . It seems apparent that du Pont's power to set the price of cellophane has been limited only by the competition afforded by the other flexible packaging materials. . . . The trial court consequently had to determine whether competition from other wrappings prevented du Pont from possessing monopoly power . . . .") (footnotes omitted).

Guidelines espoused the HMT, it had been articulated by antitrust treatises.[2] Today's leading treatise endorses the HMT,[3] and the First Circuit has held: "The touchstone of market definition is whether a hypothetical monopolist could raise prices." *Coastal Fuels of P.R., Inc. v. Caribbean Petroleum Corp.*, 79 F.3d 182, 198 (1st Cir. 1996).

Contrary to defendants' assertion, no federal antitrust decision has explicitly rejected the HMT. Courts have frequently noted that they were not bound by the Merger Guidelines, but they typically proceeded to apply the HMT nevertheless.[4] Critically, the HMT was applied, rather than rejected, in two cases most relied on by defendants.

In *Olin Corp. v. FTC*, 986 F.2d 1295 (9th Cir. 1993), the Ninth Circuit reviewed an FTC decision resting on the Guidelines, *Olin Corp.*, 113 F.T.C. 400, 595-600 (1990). The central issue was whether the FTC was justified in positing a price increase of at least 10%, as was necessary to place the merging products in the same relevant market. The court quoted the Guidelines at length and affirmed, 986 F.2d at 1299-302, which was consistent with the

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[2] 2 Phillip Areeda & Donald F. Turner, Antitrust Law ¶ 518, at 347 (1978) ("In economic terms, a 'market' embraces one firm or any group of firms which, if unified by agreement or merger, would have market power in dealing with any group of buyers."); Lawrence A. Sullivan, Handbook of the Law of Antitrust 41 (1977) ("To define a market . . . is to say that if prices were appreciably raised . . . , supply from other sources could not be expected to enter promptly enough and in large enough amounts to restore the old price . . . .").

[3] 2A Phillip E. Areeda et al., Antitrust Law ¶ 533, at 200 (2d ed. 2002) ("A 'market' is any grouping of sales whose sellers, if unified by a hypothetical cartel or merger, could profitably raise prices significantly above the competitive level."); *see id.* ¶¶ 530a, 536-38.

[4] *E.g. California v. Sutter Health Sys.*, 130 F. Supp. 2d 1109, 1120, 1128-32 (N.D. Cal. 2001) (applying the HMT and holding "[a]lthough the *Merger Guidelines* are not binding, courts have often adopted the [market delineation] standards set forth in the *Merger Guidelines*"); *New York v. Kraft Gen. Foods, Inc.*, 926 F. Supp. 321, 359-61 & n.9 (S.D.N.Y. 1995) (applying the HMT after holding "the Merger Guidelines are helpful . . . , but they are not binding upon the court"); *FTC v. Owens-Ill., Inc.*, 681 F. Supp. 27, 34 n.17, 38-46 (D.D.C. 1988), *vacated as moot*, 850 F.2d 694 (D.C. Cir. 1988) (applying the HMT after holding that "the *Guidelines* are not binding on the courts").

Guidelines' flexibility on the amount of the price increase. The Ninth Circuit later embraced the HMT in *Rebel Oil Co., Inc. v. Atl. Richfield Co.*, 51 F.3d 1421, 1434 (9th Cir. 1995).

In *United States v. Englehard Corp.*, the Eleventh Circuit declined to rule on "the validity of the 5-10% test" "as a general matter of law," instead holding that the government's evidence was insufficient under the HMT. 126 F.2d 1302, 1304-05 (11th Cir. 1997). The HMT was not rejected in favor of some alternative test. The district court had suggested that a price increase larger than 10% was best in that particular case, 970 F. Supp. 1463, 1467-68, 1484 (M.D. Ga. 1997), and the government challenged that suggestion on appeal.

Defendants urge this Court to define the market on the basis of functional interchangeability. While functional interchangeability is a relevant fact, it has never been the ultimate test. The error of using functional interchangeability as the test may be most clearly demonstrated by *United States v. Archer-Daniels-Midland Co.*, 866 F.2d 242, 246 (8th Cir. 1988), which concerned whether sugar was in the same market as lower-priced high fructose corn syrup (HFCS). The court found that it was not, despite perfect functional interchangeablity for all uses of HFCS, because an "HFCS monopolist is able to exercise excess market power." In a similar vein is *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1074-75, 1078 (D.D.C. 1997).

II. Sensible Application of the HMT in this Case Confirms the PIN Debit Market

The gravamen of the government's case is that the merged firm will raise merchant prices, consisting of an interchange fee plus a merchant switch fee. But for purposes of evaluating the response of merchants to a price increase, it does not matter how the price increase is divided between the interchange and merchant switch fees. Defendants object to the application of the HMT to two-sided markets like PIN debit networks,[5] mainly on the ground that

[5] Defendants explain that raising interchange fees may be profitable, absent market power

increasing the interchange fee is not how the networks would exercise market power. But it makes perfect sense to apply the HMT without increasing the interchange fee. The government theory makes no suggestion that the merged firm will harm banks by lowering interchange fees. Hence, a sensible application of the HMT for evaluating the government's complaint entails an increase in merchant switch fees, while holding interchange fees constant.

The evidence will establish that hardly any switching to other forms of payment would occur in response to an increase of, say, two cents in merchant fees (roughly 5-10% of total fees). Defendants note that the *Wal-Mart* settlement narrowed the price difference between PIN and signature debit faced by merchants. But the gap has not narrowed to anything close to two cents, [**Redacted**]. Defendants' assertion about eventual price convergence is mere speculation—not "business reality."

Defendants assert that Visa's conduct cannot be understood by reference only to PIN debit, but it is the merged firm that is at issue. The merged firm would react to Visa's conduct in PIN debit differently than STAR and NYCE would when competing with each other as well as Visa have, and the result would be higher total merchant fees. Furthermore, no legal principle holds that all of the influences on a firm's conduct must be included in the relevant market, and such a principle was rejected by *United States v. Microsoft Corp.*, 253 F.3d 34, 53-54 (D.C. Cir. 2001) (although middleware was central to the case, it was not in the relevant market for PC operating systems because it was not reasonably interchangeable for them).

Finally, the *Wal-Mart* complaint and settlement agreement are not inconsistent with the

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in PIN debit, because it attracts issuers and thus increases transaction volume, but this is neither important for market definition nor unique to two-sided markets. A manufacturer without market power may find it profitable to raise the price it offers for raw materials in order to attract higher quality inputs because the result may be a higher quality output appealing to more consumers.

existence of a relevant market for PIN debit network services. The core of class counsel's complaint was that Visa and MasterCard illegally tied acceptance of their credit cards to acceptance of their signature debit cards. The validity of the claim did not turn on whether either PIN or signature debit network services were separate relevant markets, and the issue was never specifically addressed by the court. Moreover, it is of no probative value that plaintiffs' damages theory was found to establish the necessary common proof for certification of the plaintiffs' class. No court passed on the factual validity of that theory.

Respectfully submitted,

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