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# Comment by Various Antitrust Scholars from the Truth on the Market Blog Symposium on the VMGs (Matter Number P810034)

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# I. Introduction

In response to the Draft Vertical Merger Guidelines released by DOJ and the FTC on January 10, 2020,[1] the International Center for Law & Economics convened a blog symposium to discuss the legal and economic implications of the proposed changes. Published on Thursday, February 6, 2020 and Friday, February 7, 2020 on TruthOnTheMarket.com, that symposium included contributions from twenty-six well respected legal academics, economists, and seasoned practitioners.[2] This Comment collects those posts together so that they can form part of the record as DOJ and the FTC consider the final form of the Vertical Merger Guidelines.

Please note, inclusion of the posts in this comment should not be interpreted as indicating that any particular author supports any post that is not his or her own — this was a broad effort that included many different viewpoints.

# II. Symposium Contributions



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[1] U.S. Dept. of Just. and Fed. Trade Comm'n, *Draft Vertical Merger Guidelines* (Jan. 10, 2020) , *available at* https://www.justice.gov/opa/press-release/file/1233741/download

[2] *See The 2020 Draft Joint Vertical Merger Guidelines: What's in, what's out – and do we need them anyway?*, TRUTHONTHEMARKET.COM, https://truthonthemarket.com/symposia/draft-vertical-merger-guidelines-symposium/

## The Illogic of a Contract/Merger Equivalency Assumption in the Assessment of Vertical Mergers



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## Against Incorporating a Contract/Merger Equivalency Assumption in Vertical Merger Guidelines



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# Hovenkamp: The Draft Vertical Merger Guidelines Are an Important Step for the Economic Analysis of Mergers

Herbert Hovenkamp — 6 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Herbert Hovenkamp (James G. Dinan University Professor, University of Pennsylvania School of Law and the Wharton School).*]

In its 2019 *AT&T/Time-Warner* merger decision the D.C. Circuit Court of Appeals mentioned something that antitrust enforcers have known for years: We need a new set of Agency Guidelines for vertical mergers. The vertical merger Guidelines were last revised in 1984 at the height of Chicago School hostility toward harsh antitrust treatment of vertical restraints. In January, 2020, the Agencies issued a set of draft vertical merger Guidelines for comment. At this writing the Guidelines are not final, and the Agencies are soliciting comments on the draft and will be holding at least two workshops to discuss them before they are finalized.

## 1. *What the Guidelines contain*

### a. "Relevant markets" and "related products"

**The draft Guidelines borrow heavily from the 2010 Horizontal Merger Guidelines concerning general questions of market definition, entry barriers, partial acquisitions, treatment of efficiencies and the failing company defense. Both the approach to market definition and the necessity for it are treated somewhat differently than for horizontal mergers, however**. First, the Guidelines do not generally speak of vertical mergers as linking two different "markets," such as an upstream market and a downstream market. Instead, they use the term "relevant market" to speak of the market that is of competitive concern, and the term "related product" to refer to some product, service, or grouping of sales that is either upstream or downstream from this market:

> A related product is a product or service that is supplied by the merged firm, is vertically related to the products and services in the relevant market, and to which access by the merged firm's rivals affects competition in the relevant market.

So, for example, if a truck trailer manufacturer should acquire a maker of truck wheels and the market of concern was trailer manufacturing, the Agencies would identify that as the relevant market and wheels as the "related product." (Cf. *Fruehauf Corp. v. FTC*).

**b. 20% market share threshold**

The Guidelines then suggest (§3) that the Agencies would be

> unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20 percent and the related product is used in less than 20 percent of the relevant market.

The choice of 20% is interesting but quite defensible as a statement of enforcement policy, and very likely represents a compromise between extreme positions. First, 20% is considerably higher than the numbers that supported enforcement during the 1960s and earlier (*see, e.g.*, *Brown Shoe* (less than 4%); *Bethlehem Steel* (10% in one market; as little as 1.8% in another market)). Nevertheless, it is also considerably lower than the numbers that commentators such as Robert Bork would have approved (*see* Robert H. Bork, The Antitrust Paradox: A Policy at War with Itself at pp. 219, 232-33; *see also* Herbert Hovenkamp, *Robert Bork and Vertical Integration: Leverage, Foreclosure, and Efficiency*), and lower than the numbers generally used to evaluate vertical restraints such as tying or exclusive dealing (*see Jefferson Parish* (30% insufficient); *see also* 9 Antitrust Law ¶1709 (4th ed. 2018)).

The Agencies do appear to be admonished by the Second Circuit's *Fruehauf* decision, now 40 years old but nevertheless the last big, fully litigated vertical merger case prior to *AT&T/Time Warner*: foreclosure numbers standing alone do not mean very much, at least not unless they are very large. Instead, there must be some theory about how foreclosure leads to lower output and higher prices. These draft Guidelines provide several examples and illustrations.

Significantly, the Guidelines do not state that they will challenge vertical mergers crossing the 20% threshold, but only that they are unlikely to challenge mergers that fall short of it. Even here, they leave open the possibility of challenge in unusual situations where the share numbers may understate the concern, such as where the related product "is relatively new," and its share is rapidly growing. The Guidelines also note (§3) that if the merging parties serve different geographic areas, then the relevant share may not be measured by a firm's gross sales everywhere, but rather by its shares in the other firm's market in which anticompetitive effects are being tested.

**These numbers as well as the qualifications seem quite realistic, particularly in product differentiated markets where market shares tend to understate power, particularly in vertical distribution**.

**c. Unilateral effects**

The draft Vertical Guidelines then divide the universe of adverse competitive effects into Unilateral Effects (§5) and Coordinated Effects (§7). The discussion of unilateral effects is based on bargaining theory similar to that used in the treatment of unilateral effects from horizontal mergers in the 2010 Horizontal Merger Guidelines. Basically, a price increase is more profitable if the losses that accrue to one merging participant are affected by gains to the merged firm as a whole. These principles have been a relatively uncontroversial part of industrial organization economics and game theory for decades. **The**

**Draft Vertical Guidelines recognize both foreclosure and raising rivals' costs as concerns, as well as access to competitively sensitive information (§5)**.

The Draft Guidelines note:

> A vertical merger may diminish competition by allowing the merged firm to profitably weaken or remove the competitive constraint from one or more of its actual or potential rivals in the relevant market by changing the terms of those rivals' access to one or more related products. For example, the merged firm may be able to raise its rivals' costs by charging a higher price for the related products or by lowering service or product quality. The merged firm could also refuse to supply rivals with the related products altogether ("foreclosure").
>
> Where sufficient data are available, the Agencies may construct economic models designed to quantify the likely unilateral price effects resulting from the merger…..

The draft Guidelines note that these models need not rely on a particular market definition. As in the case of unilateral effects horizontal mergers, they compare the firms' predicted bargaining position before and after the merger, assuming that the firms seek maximization of profits or value. They then query whether equilibrium prices in the post-merger market will be higher than those prior to the merger.

In making that determination the Guidelines suggest (§4a) that the Agency could look at several factors, including:

1. The merged firm's foreclosure of, or raising costs of, one or more rivals would cause those rivals to lose sales (for example, if they are forced out of the market, if they are deterred from innovating, entering or expanding, or cannot finance these activities, or if they have incentives to pass on higher costs through higher prices), or to otherwise compete less aggressively for customers' business;
2. The merged firm's business in the relevant market would benefit (for example if some portion of those lost sales would be diverted to the merged firm);
3. Capturing this benefit through merger may make foreclosure, or raising rivals' costs, profitable even though it would not have been profitable prior to the merger; and,
4. The magnitude of likely foreclosure or raising rivals' costs is not de minimis such that it would substantially lessen competition.

This approach, which reflects important developments in empirical economics, does entail that there will be increasing reliance on economic experts to draft, interpret, and dispute the relevant economic models.

In a brief section the Draft Guidelines also state a concern for mergers that will provide a firm with access or control of sensitive business information that could be used anticompetitively. The Guidelines do not provide a great deal of elaboration on this point.

### d. Elimination of double marginalization

The Vertical Guidelines also have a separate section (§6) discussing an offset for elimination of double marginalization. They note what has come to be the accepted economic wisdom that elimination of double marginalization can result in higher output and lower prices when it applies, but it does not invariably apply.

### e. Coordinated effects

Finally, the draft Guidelines note (§7) a concern that certain vertical mergers may enable collusion. This could occur, for example, if the merger eliminated a maverick buyer who formerly played rival sellers off

against one another. In other cases the merger may give one of the partners access to information that could be used to facilitate collusion or discipline cartel cheaters, offering this example:

> Example 7: The merger brings together a manufacturer of components and a maker of final products. If the component manufacturer supplies rival makers of final products, it will have information about how much they are making, and will be better able to detect cheating on a tacit agreement to limit supplies. As a result the merger may make the tacit agreement more effective.

## 2. *Conclusion: An increase in economic sophistication*

These draft Guidelines are relatively short, but that is in substantial part because they incorporate by reference many of the relevant points from the 2010 Guidelines for horizontal mergers. **In any event, they may not provide as much detail as federal courts might hope for, but they are an important step toward specifying the increasingly economic approaches that the agencies take toward merger analysis, one in which direct estimates play a larger role, with a comparatively reduced role for more traditional approaches depending on market definition and market share**.

They also avoid both rhetorical extremes, which are being too hostile or too sanguine about the anticompetitive potential of vertical acquisitions. **While the new draft Guidelines leave the overall burden of proof with the challenger, they have clearly weakened the presumption that vertical mergers are invariably benign, particularly in highly concentrated markets or where the products in question are differentiated**. Second, the draft Guidelines emphasize approaches that are more economically sophisticated and empirical. Consistent with that, foreclosure concerns are once again taken more seriously.




# Nuechterlein: Guidelines without Guidance on Vertical Mergers

Jonathan E. Nuechterlein — 6 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Jonathan E. Nuechterlein (Partner, Sidley Austin LLP; former General Counsel, FTC; former Deputy General Counsel, FCC).*]

[***Nuechterlein****: I represented AT&T in* United States v. AT&T, Inc. *("*AT&T/Time Warner*"), and this essay is based in part on comments I prepared on AT&T's behalf for the FTC's recent public hearings on Competition and Consumer Protection in the 21st Century. All views expressed here are my own.*]

The draft Vertical Merger Guidelines ("Draft Guidelines") might well leave ordinary readers with the misimpression that U.S. antitrust authorities have suddenly come to view vertical integration with a jaundiced eye. Such readers might infer from the draft that vertical mergers are a minefield of potential competitive harms; that only sometimes do they "have the potential to create cognizable efficiencies"; and that such efficiencies, even when they exist, often are not "of a character and magnitude" to keep the merger from becoming "anticompetitive." (Draft Guidelines § 8, at 9). But that impression would be impossible to square with the past forty years of U.S. enforcement policy and with exhaustive empirical work confirming the largely beneficial effects of vertical integration.

**The Draft Guidelines should reflect those realities and thus should incorporate genuine limiting principles — rooted in concerns about two-level market power — to cabin their highly speculative theories of harm. Without such limiting principles, the Guidelines will remain more a theoretical exercise in abstract issue-spotting than what they purport to be: a source of genuine guidance for the public**.

## 1. *The presumptive benefits of vertical integration*

Although the U.S. antitrust agencies (the FTC and DOJ) occasionally attach conditions to their approval of vertical mergers, they have litigated only one vertical merger case to judgment over the past forty years: *AT&T/Time Warner*. **The reason for that paucity of cases is neither a lack of prosecutorial zeal nor a**

**failure to understand "raising rivals' costs" theories of harm. Instead, in the words of the FTC's outgoing Bureau of Competition chief, Bruce Hoffman, the reason is the "broad consensus in competition policy and economic theory that the majority of vertical mergers are beneficial because they reduce costs and increase the intensity of interbrand competition."**

Two exhaustive papers confirm that conclusion with hard empirical facts. The first was published in the International Journal of Industrial Organization in 2005 by FTC economists James Cooper, Luke Froeb, Dan O'Brien, and Michael Vita, who surveyed "multiple studies of vertical mergers and restraints" and "found only one example where vertical integration harmed consumers, and multiple examples where vertical integration unambiguously benefited consumers." The second paper is a 2007 analysis in the Journal of Economic Literature co-authored by University of Michigan Professor Francine LaFontaine (who served from 2014 to 2015 as Director of the FTC's Bureau of Economics) and Professor Margaret Slade of the University of British Columbia. Professors LaFontaine and Slade "did not have a particular conclusion in mind when [they] began to collect the evidence," "tried to be fair in presenting the empirical regularities," and were "therefore somewhat surprised at what the weight of the evidence is telling us." They found that:

> [U]nder most circumstances, profit-maximizing vertical-integration decisions are efficient, not just from the firms' but also from the consumers' points of view. Although there are isolated studies that contradict this claim, the vast majority support it. (p. 680)

Vertical mergers have this procompetitive track record for two basic reasons. First, by definition, they do not eliminate a competitor or increase market concentration in any market, and they pose fewer competitive concerns than horizontal mergers for that reason alone. Second, as Bruce Hoffman noted, "while efficiencies are often important in horizontal mergers, they are much more intrinsic to a vertical transaction" and "come with a more built-in likelihood of improving competition than horizontal mergers."

It is widely accepted that vertical mergers often impose downward pricing pressure by eliminating double margins. Beyond that, as the Draft Guidelines observe (at § 8), vertical mergers can also play an indispensable role in "eliminate[ing] contracting frictions," "streamlin[ing] production, inventory management, or distribution," and "creat[ing] innovative products in ways that would have been hard to achieve through arm's length contracts."

## 2. *Harm to competitors, harm to competition, and the need for limiting principles*

Vertical mergers do often disadvantage *rivals* of the merged firm. For example, a distributor might merge with one of its key suppliers, achieve efficiencies through the combination, and pass some of the savings through to consumers in the form of lower prices. The firm's distribution rivals will lose profits if they match the price cut and will lose market share to the merged firm if they do not. **But that outcome obviously counts in favor of supporting, not opposing, the merger because it makes consumers better off and because "[t]he antitrust laws… were enacted for the protection of *competition* not *competitors*." (*Brunswick v Pueblo Bowl-O-Mat*).**

**This distinction between harm to competition and harm to competitors is fundamental to U.S. antitrust law. Yet key passages in the Draft Guidelines seem to blur this distinction**.

For example, one passage suggests that a vertical merger will be suspect if the merged firm might "chang[e] the terms of … rivals' access" to an input, "one or more rivals would [then] lose sales," and "some portion of those lost sales would be diverted to the merged firm." Draft Guidelines § 5.a, at 4-5. Of course, the Guidelines' drafters would never concede that they wish to vindicate the interests of competitors *qua* competitors. They would say that incremental changes in input prices, even if they do not

structurally alter the competitive landscape, might nonetheless result in slightly higher overall consumer prices. And they would insist that speculation about such slight price effects should be sufficient to block a vertical merger.

That was the precise theory of harm that DOJ pursued in *AT&T/Time Warner*, which involved a purely vertical merger between a video programmer (Time Warner) and a pay-TV distributor (AT&T/DirecTV). DOJ ultimately conceded that Time Warner was unlikely to withhold programming from ("foreclose") AT&T's pay-TV rivals. Instead, using a complex economic model, DOJ tried to show that the merger would increase Time Warner's bargaining power and induce AT&T's pay-TV rivals to pay somewhat higher rates for Time Warner programming, some portion of which the rivals would theoretically pass through to their own retail customers. At the same time, DOJ conceded that post-merger efficiencies would cause AT&T to *lower* its retail rates compared to the but-for world without the merger. DOJ nonetheless asserted that the aggregate effect of the pay-TV rivals' price increases would exceed the aggregate effect of AT&T's own price decrease. Without deciding whether such an effect would be sufficient to block the merger — a disputed legal issue — the courts ruled for the merging parties because DOJ could not substantiate its factual prediction that the merger would lead to programming price increases in the first place.

It is unclear why DOJ picked this, of all cases, as its vehicle for litigating its first vertical merger case in decades. In an archetypal raising-rivals'-costs case, familiar from exclusive dealing law, the defendant forecloses its rivals by depriving them of a critical input or distribution channel and so marginalizes them in the process that it can profitably raise its own retail prices (*see, e.g.*, *McWane*; *Microsoft*). *AT&T/Time Warner* could hardly have been further afield from that archetypal case. Again, DOJ conceded both that the merged firm would not foreclose rivals at all and that the merger would induce the firm to *lower* its retail prices below what it would charge if the merger were blocked. **The draft Guidelines appear to double down on this odd strategy and portend more cases predicated on the same attenuated concerns about mere "chang[es in] the terms of … rivals' access" to inputs, unaccompanied by any alleged structural changes in the competitive landscape**.

**Bringing such cases would be a mistake, both tactically and doctrinally**.

"Changes in the terms of inputs" are a constant fact of life in nearly every market, with or without mergers, and have almost never aroused antitrust scrutiny. For example, whenever a firm enters into a long-term preferred-provider agreement with a new business partner in lieu of merging with it, the firm will, by definition, deal on less advantageous terms with the partner's rivals than it otherwise would. That outcome is virtually never viewed as problematic, let alone unlawful, when it is accomplished through such long-term contracts. The government does not hire a team of economists to pore over documents, interview witnesses, and run abstruse models on whether the preferred-provider agreement can be projected, on balance, to produce incrementally higher downstream prices. There is no obvious reason why the government should treat such preferred provider arrangements differently if they arise through a vertical merger rather than a vertical contract — particularly given the draft Guidelines' own acknowledgement that vertical mergers produce pro-consumer efficiencies that would be "hard to achieve through arm's length contracts." (Draft Guidelines § 8, at 9).

## 3. *Towards a more useful safe harbor*

Quoting then-Judge Breyer, the Supreme Court once noted that "antitrust rules 'must be clear enough for lawyers to explain them to clients.'" That observation rings doubly true when applied to a document by enforcement officials purporting to "guide" business decisions. **Firms contemplating a vertical merger need more than assurance that their merger will be cleared two years hence if their economists vanquish the government's economists in litigation about the fine details of Nash bargaining theory. Instead, firms need true limiting principles, which identify the circumstances where any theory of harm would be so attenuated that litigating to block the merger is not worth the candle, particularly given the empirically validated presumption that most vertical mergers are pro-consumer**.

The Agencies cannot meet the need for such limiting principles with the proposed "safe harbor" as it is currently phrased in the draft Guidelines:

> The Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market." (Draft Guidelines § 3, at 3).

This anodyne assurance, with its arbitrarily low 20 percent thresholds phrased in the conjunctive, seems calculated more to preserve the agencies' discretion than to provide genuine direction to industry.

Nonetheless, the draft safe harbor does at least point in the right direction because it reflects a basic insight about two-level market power: **vertical mergers are unlikely to create competitive concerns unless the merged firm will have, or could readily obtain, market power in both upstream and downstream markets.** (*See, e.g.*, *Auburn News v. Providence Journal* ("Where substantial market power is absent at any one product or distribution level, vertical integration will not have an anticompetitive effect.")) This point parallels tying doctrine, which, like vertical merger analysis, addresses how vertical arrangements can affect competition across adjacent markets. As Justice O'Connor noted in *Jefferson Parish*, tying arrangements threaten competition

> primarily in the rare cases where power in the market for the tying product is used to create *additional* market power in the market for the *tied* product.… But such extension of market power is unlikely, or poses no threat of economic harm, unless…, [among other conditions, the seller has] power in the tying-product market… [and there is] a substantial threat that the tying seller will acquire market power in the tied-product market.

**As this discussion suggests, the "20 percent" safe harbor in the draft Guidelines misses the mark in three respects**.

*First*, as a proxy for the absence of market power, 20 percent is too low: courts have generally refused to infer market power when the seller's market share was below 30% and sometimes require higher shares. Of course, market share can be a highly overinclusive measure of market power, in that many firms with greater than a 30% share will lack market power. But it is nonetheless appropriate to use market share as a screen for further analysis.

*Second*, the draft's safe harbor appears illogically in the conjunctive, applying only "where the parties to the merger have a share in the relevant market of less than 20 percent, *and* the related product is used in less than 20 percent of the relevant market." That "and" should be an "or" because, again, vertical arrangements can be problematic only if a firm can use existing market power in a "related products" market to create or increase market power in the "relevant market."

*Third*, the phrase "the related product is *used in* less than 20 percent of the relevant market" is far too ambiguous to serve a useful role. For example, the "related product" sold by a merging upstream firm could be "used by" 100 percent of downstream buyers even though the firm's sales account for only one percent of downstream purchases of that product if the downstream buyers multi-home — i.e., source their goods from many different sellers of substitutable products. The relevant proxy for "related product" market power is thus not how many customers "use" the merging firm's product, but what percentage of overall sales of that product (including reasonable substitutes) it makes.

Of course, this observation suggests that, when push comes to shove in litigation, the government must usually define two markets: not only (1) a "relevant market" in which competitive harm is alleged to occur, but also (2) an adjacent "related product" market in which the merged firm is alleged to have market

power. Requiring such dual market definition is entirely appropriate. **Ultimately, any raising-rivals'-costs theory relies on a showing that a vertically integrated firm has some degree of market power in a "related products" market when dealing with its rivals in an adjacent "relevant market." And market definition is normally an inextricable component of a litigated market power analysis.**

If these three changes are made, the safe harbor would read:

> *The Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 30 percent, or the related product sold by one of the parties accounts for less than 30 percent of the overall sales of that related product, including reasonable substitutes.*

Like all safe harbors, this one would be underinclusive (in that many mergers outside of the safe harbor are unobjectionable) and may occasionally be overinclusive. **But this substitute language would be more useful as a genuine safe harbor because it would impose true limiting principles. And it would more accurately reflect the ways in which market power considerations should inform vertical analysis—whether of contractual arrangements or mergers**.



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# Kolasky: The DOJ and FTC Should Revise Their Proposed Vertical Merger Guidelines to Emulate the EU's

William J. Kolasky — 6 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by William J. Kolasky (Partner, Hughes Hubbard & Reed; former Deputy Assistant Attorney General, DOJ Antitrust Division), and Philip A. Giordano (Partner, Hughes Hubbard & Reed LLP).*]

[***Kolasky & Giordano****: The authors thank Katherine Taylor, an associate at Hughes Hubbard & Reed, for her help in researching this article.*]

On January 10, the Department of Justice (DOJ) withdrew the 1984 DOJ Non-Horizontal Merger Guidelines, and, together with the Federal Trade Commission (FTC), released new draft 2020 Vertical Merger Guidelines ("DOJ/FTC draft guidelines") on which it seeks public comment by February 26.[1] In announcing these new draft guidelines, Makan Delrahim, the Assistant Attorney General for the Antitrust Division, acknowledged that while many vertical mergers are competitively beneficial or neutral, "some vertical transactions can raise serious concern." He went on to explain that, "The revised draft guidelines are based on new economic understandings and the agencies' experience over the past several decades and better reflect the agencies' actual practice in evaluating proposed vertical mergers." He added that he hoped these new guidelines, once finalized, "will provide more clarity and transparency on how we review vertical transactions."[2]

**While we agree with the DOJ and FTC that the 1984 Non-Horizontal Merger Guidelines are now badly outdated and that a new set of vertical merger guidelines is needed, we question whether the draft guidelines released on January 10, will provide the desired "clarity and transparency." In our view, the proposed guidelines give insufficient recognition to the wide range of efficiencies that flow from most, if not all, vertical mergers. In addition, the guidelines fail to provide sufficiently clear standards for challenging vertical mergers, thereby leaving too much discretion in the hands of the**

**agencies as to when they will challenge a vertical merger and too much uncertainty for businesses contemplating a vertical merger.**

What is most troubling is that this did not need to be so. In 2008, the European Commission, as part of its merger process reform initiative, issued an excellent set of non-horizontal merger guidelines that adopt basically the same analytical framework as the new draft guidelines for evaluating vertical mergers.[3] The EU guidelines, however, lay out in much more detail the factors the Commission will consider and the standards it will apply in evaluating vertical transactions. That being so, it is difficult to understand why the DOJ and FTC did not propose a set of vertical merger guidelines that more closely mirror those of the European Commission, rather than try to reinvent the wheel with a much less complete set of guidelines.

Rather than making the same mistake ourselves, we will try to summarize the EU vertical mergers and to explain why we believe they are markedly better than the draft guidelines the DOJ and FTC have proposed. **We would urge the DOJ and FTC to consider revising their draft guidelines to make them more consistent with the EU vertical merger guidelines. Doing so would, among other things, promote greater convergence between the two jurisdictions, which is very much in the interest of both businesses and consumers in an increasingly global economy**.

## *The principal differences between the draft joint guidelines and the EU vertical merger guidelines*

### 1. Acknowledgement of the key differences between horizontal and vertical mergers

The EU guidelines begin with an acknowledgement that, "Non-horizontal mergers are generally less likely to significantly impede effective competition than horizontal mergers." As they explain, this is because of two key differences between vertical and horizontal mergers.

- First, unlike horizontal mergers, vertical mergers "do not entail the loss of direct competition between the merging firms in the same relevant market."[4] As a result, "the main source of anti-competitive effect in horizontal mergers is absent from vertical and conglomerate mergers."[5]
- Second, vertical mergers are more likely than horizontal mergers to provide substantial, merger-specific efficiencies, without any direct reduction in competition. The EU guidelines explain that these efficiencies stem from two main sources, both of which are intrinsic to vertical mergers. The first is that, "Vertical integration may thus provide an increased incentive to seek to decrease prices and increase output because the integrated firm can capture a larger fraction of the benefits."[6] The second is that, "Integration may also decrease transaction costs and allow for a better co-ordination in terms of product design, the organization of the production process, and the way in which the products are sold."[7]

**The DOJ/FTC draft guidelines do not acknowledge these fundamental differences between horizontal and vertical mergers**. The 1984 DOJ non-horizontal guidelines, by contrast, contained an acknowledgement of these differences very similar to that found in the EU guidelines. First, the 1984 guidelines acknowledge that, "By definition, non-horizontal mergers involve firms that do not operate in the same market. It necessarily follows that such mergers produce no immediate change in the level of concentration in any relevant market as defined in Section 2 of these Guidelines."[8] Second, the 1984 guidelines acknowledge that, "An extensive pattern of vertical integration may constitute evidence that substantial economies are afforded by vertical integration. Therefore, the Department will give relatively more weight to expected efficiencies in determining whether to challenge a vertical merger than in determining whether to challenge a horizontal merger."[9] Neither of these acknowledgements can be found in the new draft guidelines.

These key differences have also been acknowledged by the courts of appeals for both the Second and D.C. circuits in the agencies' two most recent litigated vertical mergers challenges: *Fruehauf Corp. v. FTC* in 1979[10] and *United States v. AT&T* in 2019.[11] In both cases, the courts held, as the D.C. Circuit explained

in *AT&T*, that because of these differences, the government "cannot use a short cut to establish a presumption of anticompetitive effect through statistics about the change in market concentration" – as it can in a horizontal merger case – "because vertical mergers produce no immediate change in the relevant market share."[12] Instead, in challenging a vertical merger, "the government must make a 'fact-specific' showing that the proposed merger is 'likely to be anticompetitive'" before the burden shifts to the defendants "to present evidence that the prima facie case 'inaccurately predicts the relevant transaction's probable effect on future competition,' or to 'sufficiently discredit' the evidence underlying the prima facie case."[13]

**While the DOJ/FTC draft guidelines acknowledge that a vertical merger may generate efficiencies, they propose that the parties to the merger bear the burden of identifying and substantiating those efficiencies under the same standards applied by the 2010 Horizontal Merger Guidelines**. Meeting those standards in the case of a horizontal merger can be very difficult. For that reason, **it is important that the DOJ/FTC draft guidelines be revised to make it clear that before the parties to a vertical merger are required to establish efficiencies meeting the horizontal merger guidelines' evidentiary standard, the agencies must first show that the merger is likely to substantially lessen competition, based on the type of fact-specific evidence the courts required in both *Fruehauf* and *AT&T*.**

**2. Safe harbors**

Although they do not refer to it as a "safe harbor," the DOJ/FTC draft guidelines state that,

> The Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market.[14]

If we understand this statement correctly, it means that the agencies may challenge a vertical merger in any case where one party has a 20% share in a relevant market and the other party has a 20% or higher share of any "related product," *i.e.*, any "product or service" that is supplied by the other party to firms in that relevant market.

By contrast, the EU guidelines state that,

> The Commission is unlikely to find concern in non-horizontal mergers . . . where the market share post-merger of the new entity in each of the markets concerned is below 30% . . . and the post-merger HHI is below 2,000.[15]

Both the EU guidelines and the DOJ/FTC draft guidelines are careful to explain that these statements do not create any "legal presumption" that vertical mergers below these thresholds will not be challenged or that vertical mergers above those thresholds are likely to be challenged.

**The EU guidelines are more consistent than the DOJ/FTC draft guidelines both with U.S. case law and with the actual practice of both the DOJ and FTC**. It is important to remember that the raising rivals' costs theory of vertical foreclosure was first developed nearly four decades ago by two young economists, David Scheffman and Steve Salop, as a theory of exclusionary conduct that could be used against dominant firms in place of the more simplistic theories of vertical foreclosure that the courts had previously relied on and which by 1979 had been totally discredited by the Chicago School for the reasons stated by the Second Circuit in *Fruehauf*.[16]

As the Second Circuit explained in *Fruehauf*, it was "unwilling to assume that any vertical foreclosure lessens competition" because

> [a]bsent very high market concentration or some other factor threatening a tangible anticompetitive effect, a *vertical merger* may simply realign sales patterns, for insofar as the merger forecloses some of the market from the merging firms' competitors, it may simply free up that much of the market, in which the merging firm's competitors and the merged firm formerly transacted, for new transactions between the merged firm's competitors and the merging firm's competitors.[17]

Or, as Robert Bork put it more colorfully in *The Antitrust Paradox*, in criticizing the FTC's decision in *A.G. Spalding & Bros., Inc.,*[18]:

> We are left to imagine eager suppliers and hungry customers, unable to find each other, forever foreclosed and left languishing. It would appear the commission could have cured this aspect of the situation by throwing an industry social mixer.[19]

Since David Scheffman and Steve Salop first began developing their raising rivals' cost theory of exclusionary conduct in the early 1980s, gallons of ink have been spilled in legal and economic journals discussing and evaluating that theory.[20] The general consensus of those articles is that while raising rivals' cost is a plausible theory of exclusionary conduct, proving that a defendant has engaged in such conduct is very difficult in practice. It is even more difficult to predict whether, in evaluating a proposed merger, the merged firm is likely to engage in such conduct at some time in the future.

Consistent with the Second Circuit's decision in *Fruehauf* and with this academic literature, the courts, in deciding cases challenging exclusive dealing arrangements under either a vertical foreclosure theory or a raising rivals' cost theory, have generally been willing to consider a defendant's claim that the alleged exclusive dealing arrangements violated section 1 of the Sherman Act only in cases where the defendant had a dominant or near-dominant share of a highly concentrated market — usually meaning a share of 40 percent or more.[21] Likewise, all but one of the vertical mergers challenged by either the FTC or DOJ since 1996 have involved parties that had dominant or near-dominant shares of a highly concentrated market.[22] A majority of these involved mergers that were not purely vertical, but in which there was also a direct horizontal overlap between the two parties.

One of the few exceptions is *AT&T/Time Warner*, a challenge the DOJ lost in both the district court and the D.C. Circuit.[23] The outcome of that case illustrates the difficulty the agencies face in trying to prove a raising rivals' cost theory of vertical foreclosure where the merging firms do not have a dominant or near-dominant share in either of the affected markets.

**Given these court decisions and the agencies' historical practice of challenging vertical mergers only between companies with dominant or near-dominant shares in highly concentrated markets, we would urge the DOJ and FTC to consider raising the market share threshold below which it is unlikely to challenge a vertical merger to at least 30 percent, in keeping with the EU guidelines, or to 40 percent in order to make the vertical merger guidelines more consistent with the U.S. case law on exclusive dealing**.[24] We would also urge the agencies to consider adding a market concentration HHI threshold of 2,000 or higher, again in keeping with the EU guidelines.

### 3. Standards for applying a raising rivals' cost theory of vertical foreclosure

**Another way in which the EU guidelines are markedly better than the DOJ/FTC draft guidelines is in explaining the factors taken into consideration in evaluating whether a vertical merger will give the parties both the ability and incentive to raise their rivals' costs in a way that will enable the merged entity to increase prices to consumers**. Most importantly, the EU guidelines distinguish clearly between input foreclosure and customer foreclosure, and devote an entire section to each. For brevity, we will focus only on input foreclosure to show why we believe the more detailed approach the EU guidelines take is preferable to the more cursory discussion in the DOJ/FTC draft guidelines.

In discussing input foreclosure, **the EU guidelines correctly distinguish between whether a vertical merger will give the merged firm the *ability* to raise rivals' costs in a way that may substantially lessen competition and, if so, whether it will give the merged firm an *incentive* to do so**. These are two quite distinct questions, which the DOJ/FTC draft guidelines unfortunately seem to lump together.

***The ability to raise rivals' costs*:**

The EU guidelines identify four important conditions that must exist for a vertical merger to give the merged firm the ability to raise its rivals' costs. First, the alleged foreclosure must concern an important input for the downstream product, such as one that represents a significant cost factor relative to the price of the downstream product. Second, the merged entity must have a significant degree of market power in the upstream market. Third, the merged entity must be able, by reducing access to its own upstream products or services, to affect negatively the overall availability of inputs for rivals in the downstream market in terms of price or quality. Fourth, the agency must examine the degree to which the merger may free up capacity of other potential input suppliers. If that capacity becomes available to downstream competitors, the merger may simple realign purchase patterns among competing firms, as the Second Circuit recognized in *Fruehauf*.

***The incentive to foreclose access to inputs:***

The EU guidelines recognize that the incentive to foreclose depends on the degree to which foreclosure would be profitable. In making this determination, the vertically integrated firm will take into account how its supplies of inputs to competitors downstream will affect not only the profits of its upstream division, but also of its downstream division. Essentially, the merged entity faces a trade-off between the profit lost in the upstream market due to a reduction of input sales to (actual or potential) rivals and the profit gained from expanding sales downstream or, as the case may be, raising prices to consumers. This trade-off is likely to depend on the margins the merged entity obtains on upstream and downstream sales. Other things constant, the lower the margins upstream, the lower the loss from restricting input sales. Similarly, the higher the downstream margins, the higher the profit gain from increasing market share downstream at the expense of foreclosed rivals.

The EU guidelines recognize that the incentive for the integrated firm to raise rivals' costs further depends on the extent to which downstream demand is likely to be diverted away from foreclosed rivals and the share of that diverted demand the downstream division of the integrated firm can capture. This share will normally be higher the less capacity constrained the merged entity will be relative to non-foreclosed downstream rivals and the more the products of the merged entity and foreclosed competitors are close substitutes. The effect on downstream demand will also be higher if the affected input represents a significant proportion of downstream rivals' costs or if it otherwise represents a critical component of the downstream product.

The EU guidelines recognize that the incentive to foreclose actual or potential rivals may also depend on the extent to which the downstream division of the integrated firm can be expected to benefit from higher price levels downstream as a result of a strategy to raise rivals' costs. The greater the market shares of the merged entity downstream, the greater the base of sales on which to enjoy increased margins. However, an upstream monopolist that is already able to fully extract all available profits in vertically related markets may not have any incentive to foreclose rivals following a vertical merger. **Therefore, the ability to extract available profits from consumers does not follow immediately from a very high market share; to come to that conclusion requires a more thorough analysis of the actual and future constraints under which the monopolist operates**.

Finally, the EU guidelines require the Commission to examine not only the incentives to adopt such conduct, but also the factors liable to reduce, or even eliminate, those incentives, including the possibility that the conduct is unlawful. In this regard, the Commission will consider, on the basis of a summary analysis: (i) the likelihood that this conduct would be clearly be unlawful under Community law, (ii) the likelihood that this illegal conduct could be detected, and (iii) the penalties that could be imposed.

***Overall likely impact on effective competition:***

Finally, the EU guidelines recognize that a vertical merger will raise foreclosure concerns only when it would lead to increased prices in the downstream market. This normally requires that the foreclosed suppliers play a sufficiently important role in the competitive process in the downstream market. In general, the higher the proportion of rivals that would be foreclosed in the downstream market, the more likely the merger can be expected to result in a significant price increase in the downstream market and, therefore, to significantly impede effective competition.

**In making these determinations, the Commission must under the EU guidelines also assess the extent to which a vertical merger may raise barriers to entry, a criterion that is also found in the 1984 DOJ non-horizontal merger guidelines but is strangely missing from the DOJ/FTC draft guidelines**. As the 1984 guidelines recognize, a vertical merger can raise entry barriers if the anticipated input foreclosure would create a need to enter at both the downstream and the upstream level in order to compete effectively in either market.

* * * * *

**Rather than issue a set of incomplete vertical merger guidelines, we would urge the DOJ and FTC to follow the lead of the European Commission and develop a set of guidelines setting out in more detail the factors the agencies will consider and the standards they will use in evaluating vertical mergers. The EU non-horizontal merger guidelines provide an excellent model for doing so.**

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[1] U.S. Department of Justice & Federal Trade Commission, *Draft Vertical Merger Guidelines*, available at https://www.justice.gov/opa/press-release/file/1233741/download (hereinafter cited as "DOJ/FTC draft guidelines").

[2] U.S. Department of Justice, Office of Public Affairs, "DOJ and FTC Announce Draft Vertical Merger Guidelines for Public Comment," Jan. 10, 2020, available at https://www.justice.gov/opa/pr/doj-and-ftc-announce-draft-vertical-merger-guidelines-public-comment.

[3] *See* European Commission, *Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings* (2008) (hereinafter cited as "EU guidelines"), available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008XC1018(03)&from=EN.

[4] *Id.* at § 12.

[5] *Id.*

[6] *Id.* at § 13.

[7] *Id.* at § 14. The insight that transactions costs are an explanation for both horizontal and vertical integration in firms first occurred to Ronald Coase in 1932, while he was a student at the London School of Economics. *See* Ronald H. Coase, Essays on Economics and Economists 7 (1994). Coase took five years to flesh out his initial insight, which he then published in 1937 in a now-famous article, *The Nature of the Firm*. *See* Ronald H. Coase, *The Nature of the Firm*, Economica 4 (1937). The implications of transactions costs for antitrust analysis were explained in more detail four decades later by Oliver Williamson in a book he published in 1975. *See* Oliver E. William, Markets and Hierarchies: Analysis and Antitrust Implications (1975) (explaining how vertical integration, either by ownership or contract, can, for example, protect a firm from free riding and other opportunistic behavior by its suppliers and customers). Both Coase and Williamson later received Nobel Prizes for Economics for their work recognizing the importance of

transactions costs, not only in explaining the structure of firms, but in other areas of the economy as well. *See, e.g.*, Ronald H. Coase, *The Problem of Social Cost*, J. Law & Econ. 3 (1960) (using transactions costs to explain the need for governmental action to force entities to internalize the costs their conduct imposes on others).

[8] U.S. Department of Justice, Antitrust Division, *1984 Merger Guidelines*, § 4, available at https://www.justice.gov/archives/atr/1984-merger-guidelines.

[9] EU guidelines, at § 4.24.

[10] Fruehauf Corp. v. FTC, 603 F.2d 345 (2d Cir. 1979).

[11] United States v. AT&T, Inc., 916 F.2d 1029 (D.C. Cir. 2019).

[12] *Id.* at 1032; *accord, Fruehauf,* 603 F.2d, at 351 ("A ***vertical merger***, unlike a horizontal one, does not eliminate a competing buyer or seller from the market . . . . It does not, therefore, automatically have an anticompetitive effect.") (emphasis in original) (internal citations omitted).

[13] *AT&T,* 419 F.2d, at 1032 (internal citations omitted).

[14] DOJ/FTC draft guidelines, at 3.

[15] EU guidelines, at § 25.

[16] *See* Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983).

[17] *Fruehauf*, *supra* note11, 603 F.2d at 353 n.9 (emphasis added).

[18] 56 F.T.C. 1125 (1960).

[19] Robert H. Bork, The Antitrust Paradox: A Policy at War with Itself 232 (1978).

[20] *See, e.g.,* Alan J. Meese, *Exclusive Dealing, the Theory of the Firm, and Raising Rivals' Costs: Toward a New Synthesis*, 50 Antitrust Bull., 371 (2005); David T. Scheffman and Richard S. Higgins, *Twenty Years of Raising Rivals Costs: History, Assessment, and Future*, 12 George Mason L. Rev.371 (2003); David Reiffen & Michael Vita, *Comment: Is There New Thinking on Vertical Mergers*, 63 Antitrust L.J. 917 (1995); Thomas G. Krattenmaker & Steven Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 Yale L. J. 209, 219-25 (1986).

[21] *See, e.g.*, United States v. Microsoft, 87 F. Supp. 2d 30, 50-53 (D.D.C. 1999) (summarizing law on exclusive dealing under section 1 of the Sherman Act); *id.* at 52 (concluding that modern case law requires finding that exclusive dealing contracts foreclose rivals from 40% of the marketplace); Omega Envtl, Inc. v. Gilbarco, Inc., 127 F.3d 1157, 1162-63 (9th Cir. 1997) (finding 38% foreclosure insufficient to make out prima facie case that exclusive dealing agreement violated the Sherman and Clayton Acts, at least where there appeared to be alternate channels of distribution).

[22] *See, e.g.*, United States, et al. v. Comcast, 1:11-cv-00106 (D.D.C. Jan. 18, 2011) (Comcast had over 50% of MVPD market), available at https://www.justice.gov/atr/case-document/competitive-impact-statement-72; United States v. Premdor, Civil No.: 1-01696 (GK) (D.D.C. Aug. 3, 2002) (Masonite manufactured more than 50% of all doorskins sold in the U.S.; Premdor sold 40% of all molded doors made in the U.S.), available at https://www.justice.gov/atr/case-document/final-judgment-151.

[23] *See* United States v. AT&T, Inc., 916 F.2d 1029 (D.C. Cir. 2019).

[24] *See* Brown Shoe Co. v. United States, 370 U.S. 294, (1962) (relying on earlier Supreme Court decisions involving exclusive dealing and tying claims under section 3 of the Clayton Act for guidance as to what share of a market must be foreclosed before a vertical merger can be found unlawful under section 7).



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# Slade: The Draft Vertical Merger Guidelines Are a Step in the Right Direction, But Uneven on Critical Issues

Margaret Slade — 6 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Margaret E. Slade (Professor Emeritus, Vancouver School of Economics, The University of British Columbia).*]

**A revision of the DOJ's Non-Horizontal Merger Guidelines is long overdue and the Draft Vertical Merger Guidelines ("Guidelines") takes steps in the right direction. However, the treatment of important issues can be uneven.** For example, the discussions of market definition and shares are relatively thorough whereas the discussions of anti-competitive harm and pro-competitive efficiencies are more vague.

## *Market definition, market shares, and concentration*

The Guidelines are correct in deferring to the Horizontal Merger Guidelines for most aspects of market definition, market shares, and market concentration. The relevant sections of the Horizontal Guidelines are not without problems. However, it would make no sense to use different methods and concepts to delineate horizontal markets that are involved in vertical mergers compared to those that are involved in horizontal mergers.

One aspect of market definition, however, is new: the notion of a related product, which is a product that links the up and downstream firms. Such products might be inputs, distribution systems, or sets of customers. The Guidelines set thresholds of 20% for the related product's share, as well as the parties' shares, in the relevant market.

Those thresholds are, of course, only indicative and mergers can be investigated when markets are smaller. In addition, mergers that fail to meet the share tests need not be challenged. **It would therefore**

**be helpful to have a list of factors that could be used to determine which mergers that fall below those thresholds are more likely to be investigated, and vice versa.** For example, the EU Vertical Merger Guidelines list circumstances, such as the existence of significant cross-shareholding relationships, the fact that one of the firms is considered to be a maverick, and suspicion that coordination is ongoing, under which mergers that fall into the safety zones are more apt to be investigated.

## *Elimination of double marginalization and other efficiencies*

Although the elimination of double marginalization (EDM) is a pricing externality that does not change unit costs, the Guidelines discuss EDM as the principal `efficiency' or at least they have more to say about that factor. Furthermore, after discussing EDM, the Guidelines note that the full EDM benefit might not occur if the downstream firm cannot use the product or if the parties are already engaged in contracting. The first factor is obvious and the second implies that the efficiency is not merger specific. **In practice, however, antitrust and regulatory policy has tended to apply the EDM argument uncritically, ignoring several key assumptions and issues**.

**The simple model of EDM relies on a setting in which there are two monopolists, one up and one downstream, each produces a single product, and production is subject to fixed proportions. This model predicts that welfare will increase after a vertical merger. If these assumptions are violated, however, the predictions change** (as John Kwoka and I discuss in more detail here). For example, under variable proportions the unintegrated downstream firm can avoid some of the adverse effects of the inflated wholesale price by substituting away from use of that product, and the welfare implications are ambiguous. Moreover, managerial considerations such as independent pricing by divisions can lead to less-than-full elimination of double marginalization.

With multi-product firms, the integrated firm's average downstream prices need not fall and can even rise when double marginalization is eliminated. To illustrate, after EDM the products with eliminated margins become relatively more profitable to sell. This gives the integrated firm incentives to divert demand towards those products by increasing the prices of its products for which double marginalization was not eliminated. Moreover, under some circumstances, the integrated downstream price can also rise.

**Since violations of the simple model are present in almost all cases, it would be helpful to include a more complete list of factors that cause the simple model — the one that predicts that EDM is always welfare improving — to fail**.

Unlike the case of horizontal mergers, with vertical mergers, real productive efficiencies on the supply side are often given less attention. **Those efficiencies, which include economies of scope, the ability to coordinate other aspects of the vertical chain such as inventories and distribution, and the expectation of productivity growth due to knowledge transfers, can be important**.

**Moreover, organizational efficiencies, such as mitigating contracting, holdup, and renegotiation costs, facilitating specific investments in physical and human capital, and providing appropriate incentives within firms, are usually ignored. Those efficiencies can be difficult to evaluate. Nevertheless, they should not be excluded from consideration on that basis**.

## *Equilibrium effects*

On page 4, the Guidelines suggest that merger simulations might be used to quantify unilateral price effects of vertical mergers. However, they have nothing to say about the pitfalls. **Unfortunately, compared to horizontal merger simulations, there are many more assumptions that are required to construct vertical simulation models and thus many more places where they can go wrong**. In particular, one must decide on the number and identity of the rivals; the related products that are potentially disadvantaged; the geographic markets in which foreclosure or raising rivals' costs are likely to

occur; the timing of moves: whether up and downstream prices are set simultaneously or the upstream firm is a first mover; the link between up and downstream: whether bargaining occurs or the upstream firm makes take-it-or-leave-it offers; and, as I discuss below, the need to evaluate the raising rivals' costs (RRC) and elimination of double marginalization (EDM) effects simultaneously.

**These choices can be crucial in determining model predictions**. **Indeed, as William Rogerson notes** (in an unpublished 2019 draft paper, *Modeling and Predicting the Competitive Effects of Vertical Mergers Due to Changes in Bargaining Leverage: The Bargaining Leverage Over Rivals (BLR) Effect*), **when moves are simultaneous, there is no RRC effect**. This is true because, when negotiating over input prices, firms take downstream prices as given.

On the other hand, bargaining introduces a new competitive effect — the bargaining leverage effect — which arises because, after a vertical merger, the disagreement payoff is higher. Indeed, the merged firm recognizes the increased profit that its downstream integrated division will earn if the input is withheld from the rival. In contrast, the upstream firm's disagreement payoff is irrelevant when it has all of the bargaining power.

Finally, on page 5, the Guidelines describe something that sounds like a vertical upward pricing pressure (UPP) index, analogous to the GUPPI that has been successfully employed in evaluating horizontal mergers. **However, extending the GUPPI to a vertical context is not straightforward**.

To illustrate, Das Varma and Di Stefano show that a sequential process can be very misleading, where a sequential process consists of first calculating the RRC effect and, if that effect is substantial, evaluating the EDM effect and comparing the two. The problem is that the two effects are not independent of one another. Moreover, when the two are determined simultaneously, compared to the sequential RRC, the equilibrium RRC can increase or decrease and can even change sign (i.e., lowering rival costs).**What these considerations mean is that vertical merger simulations have to be carefully crafted to fit the markets that are susceptible to foreclosure and that a one-size-fits-all model can be very misleading. Furthermore, if a simpler sequential screening process is used, careful consideration must be given to whether the markets of interest satisfy the assumptions under which that process will yield approximately reasonable results**.



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# Wright, Ginsburg, Lipsky and Yun: Connecting Vertical Merger Guidelines to Sound Economics

Josh Wright, Doug Ginsburg, Tad Lipsky, and John Yun — 6 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*]

*This post is authored by Joshua D. Wright (University Professor of Law, George Mason University and former Commissioner, FTC); Douglas H. Ginsburg (Senior Circuit Judge, US Court of Appeals for the DC Circuit; Professor of Law, George Mason University; and former Assistant Attorney General, DOJ Antitrust Division); Tad Lipsky (Assistant Professor of Law, George Mason University; former Acting Director, FTC Bureau of Competition; former chief antitrust counsel, Coca-Cola; former Deputy Assistant Attorney General, DOJ Antitrust Division); and John M. Yun (Associate Professor of Law, George Mason University; former Acting Deputy Assistant Director, FTC Bureau of Economics).*]

After much anticipation, the Department of Justice Antitrust Division and the Federal Trade Commission released a draft of the Vertical Merger Guidelines (VMGs) on January 10, 2020. The Global Antitrust Institute (GAI) will be submitting formal comments to the agencies regarding the VMGs and this post summarizes our main points.

The Draft VMGs supersede the 1984 Merger Guidelines, which represent the last guidance from the agencies on the treatment of vertical mergers. The VMGs provide valuable guidance and greater clarity in terms of how the agencies will review vertical mergers going forward. **While the proposed VMGs generally articulate an analytical framework based upon sound economic principles, there are several ways that the VMGs could more deeply integrate sound economics and our empirical understanding of the competitive consequences of vertical integration**.

In this post, we discuss four issues: (1) incorporating the elimination of double marginalization (EDM) into the analysis of the likelihood of a unilateral price effect; (2) eliminating the role of market shares and structural analysis; (3) highlighting that the weight of empirical evidence supports the proposition that vertical mergers are less likely to generate competitive concerns than horizontal mergers; and (4) recognizing the importance of transaction cost-based efficiencies.

### *Elimination of double marginalization is a unilateral price effect*

EDM is discussed separately from both unilateral price effects, in Section 5, and efficiencies, in Section 9, of the draft VMGs. This is notable because **the structure of the VMGs obfuscates the relevant economics of internalizing pricing externalities and may encourage the misguided view that EDM is a special form of efficiency**.

When separate upstream and downstream entities price their products, they do not fully take into account the impact of their pricing decision on each other — even though they are ultimately part of the same value chain for a given product. Vertical mergers eliminate a pricing externality since the post-merger upstream and downstream units are fully aligned in terms of their pricing incentives. In this sense, EDM is indistinguishable from the unilateral effects discussed in Section 5 of the VMGs that cause upward pricing pressure. Specifically, in the context of mergers, just as there is a greater incentive, under certain conditions, to foreclose or raise rivals' costs (RRC) post-merger (although, this does not mean there is an *ability* to engage in these behaviors), there is also an incentive to *lower* prices due to the elimination of a markup along the supply chain. **Consequently, we really cannot assess unilateral effects without accounting for the full set of incentives that could move prices in either direction**.

Further, it is improper to consider EDM in the context of a "net effect" given that this phrase has strong connotations with weighing efficiencies against findings of anticompetitive harm. Rather, "unilateral price effects" actually includes EDM — just as a finding that a merger will induce entry properly belongs in a unilateral effects analysis. **For these reasons, we suggest incorporating the discussion of EDM into the discussion of unilateral effects contained in Section 5 of the VMGs and eliminating Section 6**. Otherwise, by separating EDM into its own section, the agencies are creating a type of "limbo" between unilateral effects and efficiencies — which creates confusion, particularly for courts. **It is also important to emphasize that the mere existence of alternative contracting mechanisms to mitigate double marginalization does not tell us about their relative efficacy compared to vertical integration as there are costs to contracting**.

### *Role of market shares and structural analysis*

In Section 3 ("Market Participants, Market Shares, and Market Concentration"), there are two notable statements. First,

> [t]he Agencies…do not rely on changes in concentration as a screen for or indicator of competitive effects from vertical theories of harm.

This statement, without further explanation, is puzzling as there are no changes in concentration for vertical mergers. Second, the VMGs then go on to state that

> [t]he Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market.

The very next sentence reads:

> In some circumstances, mergers with shares below the thresholds can give rise to competitive concerns.

From this, we conclude that the VMGs are adopting a prior belief that, if both the relevant product and the related product have a less than 20 percent share in the relevant market, the acquisition is either competitively neutral or benign. The VMGs make clear, however, they do not offer a safe harbor. With

these statements, the agencies run the risk that the 20 percent figure will be interpreted as a trigger for competitive concern. **There is no sound economic reason to believe 20 percent share in the relevant market or the related market is of any particular importance to predicting competitive effects. The VMGs should eliminate the discussion of market shares altogether. At a minimum, the final guidelines would benefit from some explanation for this threshold if it is retained**.

## *Empirical evidence on the welfare impact of vertical mergers*

In contrast to vertical mergers, horizontal mergers inherently involve a degree of competitive overlap and an associated loss of at least some degree of rivalry between actual and/or potential competitors. **The price effect for vertical mergers, however, is generally theoretically ambiguous — even before accounting for efficiencies — due to EDM and the uncertainty regarding whether the integrated firm has an incentive to raise rivals' costs or foreclose**. Thus, for vertical mergers, empirically evaluating the welfare effects of consummated mergers has been and remains an important area of research to guide antitrust policy.

**Consequently, what is noticeably absent from the draft guidelines is an empirical grounding**. Consistent empirical findings should inform agency decision-making priors. With few exceptions, the literature does not support the view that these practices are used for anticompetitive reasons — *see* Lafontaine & Slade (2007) and Cooper et al. (2005). (For an update on the empirical literature from 2009 through 2018, which confirms the conclusions of the prior literature, see the GAI's Comment on Vertical Mergers submitted during the recent FTC Hearings.) Thus, **the modern antitrust approach to vertical mergers, as reflected in the antitrust literature, should reflect the empirical reality that vertical relationships are generally procompetitive or neutral**.

The bottom line is that how often vertical mergers are anticompetitive should influence our framework and priors. **Given the strong empirical evidence that vertical mergers do not tend to result in welfare losses for consumers, we believe the agencies should consider at least the modest statement that vertical mergers are more often than not procompetitive or, alternatively, vertical mergers tend to be more procompetitive or neutral than horizontal ones**. Thus, we believe the final VMGs would benefit from language similar to the 1984 VMGs: "Although nonhorizontal mergers are less likely than horizontal mergers to create competitive problems, they are not invariably innocuous."

## *Transaction cost efficiencies and merger specificity*

The VMGs address efficiencies in Section 8. Under the VMGs, the Agencies will evaluate efficiency claims by the parties using the approach set forth in Section 10 of the 2010 Horizontal Merger Guidelines. Thus, efficiencies must be both cognizable and merger specific to be considered by the agencies.

In general, the VMGs also adopt an approach that is consistent with the teachings of the robust literature on transaction cost economics, which recognizes the costs of using the price system to explain the boundaries of economic organizations, and the importance of incorporating such considerations into any antitrust analyses. **In particular, this literature has demonstrated, both theoretically and empirically, that the decision to contract or vertically integrate is often driven by the relatively high costs of contracting as well as concerns regarding the enforcement of contracts and opportunistic behavior**. This literature suggests that such transactions cost efficiencies in the vertical merger context often will be both cognizable and merger-specific and rejects an approach that would presume such efficiencies are not merger specific because they can be theoretically achieved via contract.

While we agree with the overall approach set out in the VMGs, we are concerned that the application of Section 8, in practice, without more specificity and guidance, will be carried out in a way that is inconsistent with the approach set out in Section 10 of the 2010 HMGs.

## *Conclusion*

**Overall, the agencies deserve credit for highlighting the relevant factors in assessing vertical mergers and for not attempting to be overly aggressive in advancing untested merger assessment tools or theories of harm**.

The agencies should seriously consider, however, refinements in a number of critical areas:

- First, discussion of EDM should be integrated into the larger unilateral effects analysis in Section 5 of the VMGs.
- Second, the agencies should eliminate the role of market shares and structural analysis in the VMGs.
- Third, the final VMGs should acknowledge that vertical mergers are less likely to generate competitive concerns than horizontal mergers.
- Finally, the final VMGs should recognize the importance of transaction cost-based efficiencies.

We believe incorporating these changes will result in guidelines that are more in conformity with sound economics and the empirical evidence.



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# Werden and Froeb: The Conspicuous Silences of the Proposed Vertical Merger Guidelines

Greg Werden and Luke Froeb — 6 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*]

*This post is authored by Gregory J. Werden (former Senior Economic Counsel, DOJ Antitrust Division (ret.)) and Luke M. Froeb (William C. Oehmig Chair in Free Enterprise and Entrepreneurship, Owen School of Management, Vanderbilt University; former Chief Economist, DOJ Antitrust Division; former Chief Economist, FTC).*]

**The proposed Vertical Merger Guidelines provide little practical guidance, especially on the key issue of what would lead one of the Agencies to determine that it will not challenge a vertical merger.** Although they list the theories on which the Agencies focus and factors the Agencies "may consider," **the proposed Guidelines do not set out conditions necessary or sufficient for the Agencies to conclude that a merger likely would substantially lessen competition. Nor do the Guidelines communicate generally how the Agencies analyze the nature of a competitive process and how it is apt to change with a proposed merger.**

The proposed Guidelines communicate the Agencies' enforcement policy in part through silences. For example, the Guidelines do not mention several theories that have appeared in recent commentary and thereby signal that Agencies have decided not to base their analysis on those theories. That silence is constructive, but the Agencies' silence on the nature of their concern with vertical mergers is not. Since 1982, the Agencies' merger guidelines have always stated that their concern was market power. Silence on this subject might suggest that the Agencies' enforcement against vertical mergers is directed to something else.

**The Guidelines' most conspicuous silence concerns the Agencies' general attitude toward vertical mergers, and on how vertical and horizontal mergers differ**. This silence is deafening: Horizontal mergers combine substitutes, which tends to reduce competition, while vertical mergers combine complements, which tends to enhance efficiency and thus also competition. Unlike horizontal mergers, vertical mergers produce anticompetitive effects only through indirect mechanisms with many moving

parts, which makes the prediction of competitive effects from vertical mergers more complex and less certain.

The Guidelines also are unhelpfully silent on the basic economics of vertical integration, and hence of vertical mergers. **In assessing a vertical merger, it is essential to appreciate that vertical mergers solve coordination problems that are solved less well, or not at all, by contracts. By solving different coordination problems, a vertical merger can generate merger-specific efficiencies or eliminate double marginalization**. But solving a coordination problem need not be a good thing: Competition is the ultimate coordination problem, and a vertical merger can have anticompetitive consequences by helping to solve that coordination problem. **Finally, the Guidelines are unhelpfully silent on the fundamental policy issue presented by vertical merger enforcement: What distinguishes a vertical merger that harms competition from a vertical merger that merely harm competitors?** A vertical merger cannot directly eliminate rivalry by increasing market concentration. The Supreme Court has endorsed a foreclosure theory under which the merger directly causes injury to a rival and thus proximately causes diminished rivalry. Vertical mergers also might diminish rivalry in other ways, but the proposed Guidelines do not state that the Agencies view diminished rivalry as the hallmark of a lessening of competition.



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# Jacobson: Vertical Mergers 2020 — A Missed Opportunity to Clarify Merger Analysis

Jonathan M. Jacobson — 6 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Jonathan M. Jacobson (Partner, Wilson Sonsini Goodrich & Rosati), and Kenneth Edelson (Associate, Wilson Sonsini Goodrich & Rosati).*]

**So we now have 21st Century Vertical Merger Guidelines, at least in draft. Yay. Do they tell us anything? Yes! Do they tell us much? No. But at least it's a start.**

* * * * *

In November 2018, the FTC held hearings on vertical merger analysis devoted to the questions of whether the agencies should issue new guidelines, and what guidance those guidelines should provide. And, indeed, on January 10, 2020, the DOJ and FTC issued their new Draft Vertical Merger Guidelines ("Draft Guidelines"). That new guidance has finally been issued is a welcome development. The antitrust community has been calling for new vertical merger guidelines for some time. The last vertical merger guidelines were issued in 1984, and there is broad consensus in the antitrust community – despite vigorous debate on correct legal treatment of vertical mergers – that the '84 Guidelines are outdated and should be withdrawn. Despite disagreement on the best enforcement policy, there is general recognition that the legal rules applicable to vertical mergers need clarification. New guidelines are especially important in light of recent high-visibility merger challenges, including the government's challenge to the *ATT/Time Warner* merger, the first vertical merger case litigated since the 1970s. These merger challenges have occurred in an environment in which there is little up-to-date case law to guide courts or agencies and the '84 Guidelines have been rendered obsolete by subsequent developments in economics.

**The discussion here focuses on what the new Draft Guidelines do say, key issues on which they do not weigh in, and where additional guidance would be desirable**.

## *What the Draft Guidelines do say*

The Draft Guidelines start with a relevant market requirement – making clear that the agencies will identify at least one relevant market in which a vertical merger may foreclose competition. However, the Draft Guidelines do not require a market definition for the vertically related upstream or downstream market(s) in the merger. Rather, the agencies' proposed policy is to identify one or more "related products." The Draft Guidelines define a related product as

> a product or service that is supplied by the merged firm, is vertically related to the products and services in the relevant market, and to which access by the merged firm's rivals affects competition in the relevant market.

The Draft Guidelines' most significant (and most concrete) proposal is a loose safe harbor based on market share and the percentage of use of the related product in the relevant market of interest. The Draft Guidelines suggest that agencies are not likely to challenge mergers if two conditions are met: (1) the merging company has less than 20% market share in the relevant market, and (2) less than 20% of the relevant market uses the related product identified by the agencies.

**This proposed safe harbor is welcome. Generally, in order for a vertical merger to have anticompetitive effects, both the upstream and downstream markets involved need to be concentrated, and the merging firms' shares of both markets have to be substantial – although the Draft Guidelines do not contain any such requirements**. Mergers in which the merging company has less than a 20% market share of the relevant market, and in which less than 20% of the market uses the vertically related product are unlikely to have serious anticompetitive effects.

**However, the proposed safe harbor does not provide much certainty**. After describing the safe harbor, the Draft Guidelines offer a caveat: meeting the proposed 20% thresholds will not serve as a "rigid screen" for the agencies to separate out mergers that are unlikely to have anticompetitive effects. **Accordingly, the guidelines as currently drafted do not guarantee that vertical mergers in which market share and related product use fall below 20% would be immune from agency scrutiny**. So, while the proposed safe harbor is a welcome statement of good policy that may guide agency staff and courts in analyzing market share and share of relevant product use, it is not a true safe harbor. This ambiguity limits the safe harbor's utility for the purpose of counseling clients on market share issues.

The Draft Guidelines also identify a number of specific unilateral anticompetitive effects that, in the agencies' view, may result from vertical mergers (the Draft Guidelines note that coordinated effects will be evaluated consistent with the Horizontal Merger Guidelines). Most importantly, the guidelines name raising rivals' costs, foreclosure, and access to competitively sensitive information as potential unilateral effects of vertical mergers. The Draft Guidelines indicate that the agency *may* consider the following issues: would foreclosure or raising rivals' costs (1) cause rivals to lose sales; (2) benefit the post-merger firm's business in the relevant market; (3) be profitable to the firm; and (4) be beyond a *de minimis* level, such that it could substantially lessen competition? Mergers where all four conditions are met, the Draft Guidelines say, often warrant competitive scrutiny. **While the big picture guidance about what agencies find concerning is helpful, the Draft Guidelines are short on details that would make this a useful statement of enforcement policy, or sufficiently reliable to guide practitioners in counseling clients. Most importantly, the Draft guidelines give no indication of what the agencies will consider a *de minimis* level of foreclosure.**

The Draft Guidelines also articulate a concern with access to competitively sensitive information, as in the recent *Staples/Essendant* enforcement action. There, the FTC permitted the merger after imposing a firewall that blocked Staples from accessing certain information about its rivals held by Essendant. This contrasts with the current DOJ approach of hostility to behavioral remedies.

## *What the Draft Guidelines don't say*

The Draft Guidelines also decline to weigh in on a number of important issues in the debates over vertical mergers. Two points are particularly noteworthy.

**First, the Draft Guidelines decline to allocate the parties' proof burdens on key issues**. The burden-shifting framework established in *U.S. v. Baker Hughes* is regularly used in horizontal merger cases, and was recently adopted in *AT&T/Time-Warner* in a vertical context. The framework has three phases: (1) the plaintiff bears the burden of establishing a prima facie case that the merger will substantially lessen competition in the relevant market; (2) the defendant bears the burden of producing evidence to demonstrate that the merger's procompetitive effects outweigh the alleged anticompetitive effects; and (3) the plaintiff bears the burden of countering the defendant's rebuttal, and bears the ultimate burden of persuasion. Virtually everyone agrees that this or some similar structure should be used. **However, the Draft Guidelines' silence on the appropriate burden is consistent with the agencies' historical practice**: The 2010 Horizontal Merger Guidelines allocate no burdens and the 1997 Merger Guidelines explicitly decline to assign the burden of proof or production on any issue.

**Second, the Draft Guidelines take an unclear approach to elimination of double marginalization (EDM)**. The appropriate treatment of EDM has been one of the key topics in the debates on the law and economics of vertical mergers, but **the Draft Guidelines take no position on the key issues in the conversation about EDM: whether it should be presumed in a vertical merger, and whether it should be presumed to be merger-specific**.

EDM may occur if two vertically related firms merge and the new firm captures the margins of both the upstream and downstream firms. After the merger, the downstream firm gets its input at cost, allowing the merged firm to eliminate one party's markup. This makes price reduction profitable for the merged firm where it would not have been for either firm before the merger.

The Draft Guidelines state that the agencies will not challenge vertical mergers where EDM means that the merger is unlikely to be anticompetitive. OK. Duh. However, they also claim that in some situations, EDM may not occur, or its benefits may be offset by other incentives for the merged firm to raise prices. The Draft Guidelines do not weigh in on whether it should be presumed that vertical mergers will result in EDM, or whether it should be presumed that EDM is merger-specific.

These are the most important questions in the debate over EDM. Some economists take the position that EDM is not guaranteed, and not necessarily merger-specific. Others take the position that EDM is basically inevitable in a vertical merger, and is unlikely to be achieved without a merger. That is: if there is EDM, it should be presumed to be merger-specific. Those who take the former view would put the burden on the merging parties to establish pricing benefits of EDM and its merger-specificity.

**Our own view is that this efficiency is pervasive and significant in vertical mergers. The defense should therefore bear only a burden of producing evidence, and the agencies should bear the burden of disproving the significance of EDM where shown to exist**. This would depart from the typical standard in a merger case, under which defendants must prove the reality, magnitude, and merger-specific character of the claimed efficiencies (the Draft Guidelines adopt this standard along with the approach of the 2010 Horizontal Merger Guidelines on efficiencies). However, it would more closely reflect the economic reality of most vertical mergers.

## *Conclusion*

**While the Draft Guidelines are a welcome step forward in the debates around the law and economics of vertical mergers, they do not guide very much**. The fact that the Draft Guidelines highlight certain issues is a useful indicator of what the agencies find important, but not a meaningful statement of enforcement policy.

**On a positive note, the Draft Guidelines' explanations of certain economic concepts important to vertical mergers may serve to illuminate these issues for courts**.

**However, the agencies' proposals are not specific enough to create predictability for business or the antitrust bar or provide meaningful guidance for enforcers to develop a consistent enforcement policy. This result is not surprising given the lack of consensus on the law and economics of vertical mergers and the best approach to enforcement**. But the antitrust community — and all of its participants — would be better served by a more detailed document that commits to positions on key issues in the relevant debates.



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# Brennan: Guidance on Enforcement Against “Pure” Vertical Mergers: It’s Complicated

Tim Brennan — 7 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*]

*This post is authored by Timothy J. Brennan (Professor, Public Policy and Economics, University of Maryland; former Chief Economist, FCC; former economist, DOJ Antitrust Division).*]

The DOJ Antitrust Division and the FTC have issued draft proposed Vertical Merger Guidelines (VMGs). These have been long-desired in some quarters, and long-dreaded in others. The controversy remains, although those who long desired them may dread what they got, and vice versa.

I’ve accepted Geoff’s invitation to offer some short thoughts on this blessedly short draft. **I’ll focus on what one might call “pure” vertical mergers, as opposed to those based on concerns regarding potential entry or expansion by a vertically integrated firm into its upstream or downstream market. After looking at what the draft classifies as unilateral effects, I’ll then turn briefly to coordinated effects, burden of proof, and the whether we want to go there at all**.

## *A notable omission*

It’s useful to think of pure vertical mergers mergers in a reverse direction; that is, not the harms they would create, but the benefits of blocking the merger even if it were harmful. The usual argument against prosecuting such mergers is that one would be left with separate firms charging above-competitive prices at one end or the other — and if they do it at both ends, creating double marginalization.

**In that regard, the draft has a notable omission: a skeptical eye toward mergers when a firm with market power is unable to charge a consequently high price**. The usual justification is price regulation of a monopoly. Concern about the harm of vertical integration as a means to evade such regulation was the basis for the divestiture by AT&T of its then-regulated, then-monopoly local telephone companies, the mirror image of blocking a vertical merger. This concern also formed the basis of Federal Energy Regulatory Commission orders (here and here) separating control of regulated electricity transmission lines from ownership of unregulated generation.

More controversially, one could apply this in contexts where pricing is limited by something other than explicit regulation. TOTM has recently featured a debate between Geoff Manne and Dirk Auer on one side and Mark Lemley, Doug Melamed, and Steve Salop regarding the FTC's case against Qualcomm's licensing practices, where the issue (I think) is about whether FRAND licensing requirements limit Qualcomm's ability to extract the full rental value of its patents. Perhaps even more out there, I've suggested that transaction costs keeping Google from charging directly for search could justify concern with discrimination in favor of its offerings in other markets, without having to reject a consumer welfare standard and where "free" search could justify rather than impede an antitrust case. **Whether non-regulatory restrictions on price should justify vertical concerns is, to say the least, complicated. You'll see that word often, and I'll come back to it at the end**.

## *Raising rivals' costs and foreclosure: Why would the merger matter?*

The seeming truism of raising rivals' costs is that to raise someone's costs, you have to raise the price of an input they use or a complement they need. If a merger (or vertical restraint) extends control over an input or complement, the competitive risk arises because that complement market is being monopolized. Accordingly, enforcers need to ensure they are looking at competition and ease of entry in the market that's being monopolized, not the market in which the bad guy who benefits might operate. For example, in the case involving Intel's loyalty rebates to computer makers that allegedly excluded AMD's processing chips, the relevant market was not chips but computers, and it is necessary to explain why AMD couldn't get new computer makers to use its chips or vertically integrate itself into computers.

With a "pure" vertical merger, however, the raising rivals' cost or foreclosure story depends not on the creation or expansion of market power over an input or complement. It must depend on how vertical integration leads to the exercise of power in that market that was not being exercised before. That requires that vertical integration changes the strategic interactions determining price and quality.

If this is the story, however, the agencies should make clear that they bear an obligation to explain how vertical integration matters, rather than assume a competitive outcome otherwise. The recent (failed) Justice Department challenge to AT&T's vertical acquisition of Time Warner programming bears this out. DOJ's core claim was that post-merger, Time Warner program services (HBO, CNN) would strike tougher deals with other video distributors, leading to higher licensing fees, because they would know that a failed negotiation would increase subscribership to AT&T. However, once a program service licenses to any video distributor, it realizes that if other video distributors don't take their service, it will increase subscribers and profits from its initial deal. If that change in bargaining position benefits whoever gets the first deal, distributors presumably can cut a deal to be the first, without vertical merger being necessary.

Might vertical merger still matter? Perhaps, but **plaintiffs should have to explain what transaction costs prevent such a nominally anticompetitive deal. Critics of indifference to vertical mergers, and the draft VMGs, point out that double marginalization might be eliminated without vertical integration, through use of contracts that include fixed fees and sales at marginal cost. A similar skepticism regarding the need for vertical integration to achieve anticompetitive ends is similarly appropriate. Establishing that need may be, well, complicated**.

## *Coordination and symmetry*

I have less to say about coordinated effects. Knowing when firms decide to switch from competing to cooperating is probably a matter of psychology and sociology as much as economics. However, economics does suggest that collusion is more likely the more symmetric are the positions of the potential colluders, to help find a mutually agreeable tactic and reduce the need for side payments and the like. To the extent symmetry is relevant, a pure vertical merger will facilitate collusion only if other market participants were similarly integrated. And absent market-wide collusion to integrate, this integration of the other

participants could be reasonably interpreted as evidence of efficiencies of vertical integration. This would make a coordinated effects vertical merger case, well, complicated.

## *The burden of proof*

As part of a widely voiced dissatisfaction with the last few decades of antitrust enforcement, some commentators have suggested that vertical mergers deserve no more of a presumption of being good than horizontal mergers. **I would argue that the strength of evidence necessary to block a vertical merger should remain greater than that for horizontal mergers**. This is not (just) because mergers between complements are more likely to lead prices to fall — eliminating double marginalization being an example — while horizontal mergers are likely to bring about upward pricing pressure. It is that the behavior that warrants concern with horizontal mergers, joint price setting, is illegal. Thus, the horizontal merger might be the only way to enable that conduct.

Contracting alternatives to vertical merger abound, as two-part pricing to eliminate double marginalization and sequential per-subscriber pricing in video markets illustrate. Absent regulation, the transaction costs necessary to create and exercise market power but for vertical integration will be lower than those necessary to create and exercise that power but for horizontal merger. This difference in transaction costs means that horizontal merger is more likely to be necessary for harm than vertical merger. Thus, proving that the latter are harmful should be, well, more complicated.

## *So, are pure vertical mergers worth the trouble to prosecute?*

Vertical mergers might be problematic, but cases are necessarily going to be complicated. This raises the question of whether the benefits of prosecuting such mergers are worth the costs, at least outside the regulated industry context. These costs are not just the cost of litigation but the costs to companies of having to hire antitrust counsel and consultants to try to determine whether their merger is likely to be challenged, how much negotiation with the agencies will be entailed, and what the likelihood of loss in court will be. Some aspects of antitrust enforcement, primarily determining who competes with whom and how much, are inevitably complicated. **But it is not clear that we are better off expending the resources to see whether something is bad, rather than accepting the cost of error from adopting imperfect rules — even rules that imply strict enforcement. Pure vertical merger may be an example of something that we might just want to leave be**.




# Cernak: Who Bears the Burden on Elimination of Double Marginalization in the Draft Vertical Merger Guidelines?

Steven J Cernak — 7 February 2020 — Leave a comment

[***TOTM**: The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Steven J. Cernak (Partner, Bona Law; Adjunct Professor, University of Michigan Law School and Western Michigan University Thomas M. Cooley Law School; former antitrust counsel, GM).*]

[***Cernak**: This paper represents the current views of the author alone and not necessarily the views of any past, present, or future employer or client.*]

## *What should we make of Cmr. Chopra's and Cmr. Slaughter's dissents?*

When I first heard that the FTC and DOJ Antitrust Division issued the draft Vertical Merger Guidelines late on Friday January 10, I did not rush out and review them to form an opinion, antitrust geek though I am. The issuance was not a surprise, given that the 1984 Guidelines were more than 35 years old and described as outdated by all observers, including those at an FTC hearing more than a year earlier. So I was surprised when I saw some pundits, especially on Twitter, immediately found the new draft controversial and I learned that two of the FTC Commissioners had not supported the release. Surely nobody was a big 1984 supporter other than fans of Orwell, Bowie, and Morris, right?

Some of my confusion dissipated as I had a chance to read and analyze the draft guidelines and the accompanying statements of Commissioners Wilson, Slaughter, and Chopra. First, Commissioners Slaughter and Chopra only abstained from the decision to release the draft for public comment. In their statements, they explained their actions as necessary to register their disagreement with the terms of this particular draft but that they too joined the chorus calling for repudiation of the 1984 Guidelines.

But some of my confusion remained as I went over Commissioner Chopra's statement again. Instead of objections to particular provisions of the draft guidelines, the statement is more of a litany of complaints on all that is wrong with today's economy and antitrust policy's role in it. Those complaints are ones we have heard from Commissioner Chopra before. They certainly should be part of the general policy debate; however, they seem to go well beyond competitive issues that might be raised by vertical mergers and that should be part of a set of guidelines.

As the first sentence and footnote of the draft guidelines make clear, the draft guidelines are meant to "outline the principal analytical techniques, practices and enforcement policy of … the Agencies" and "reflect the ongoing accumulation of experience at the Agencies." They are written to provide some guidance to potential merging parties and their advisers as to how the Agencies are likely to analyze a merger and, so, provide some greater level of certainty. That does not mean that the guidelines are meant to capture the techniques of the Agencies in amber forever – or even 35 years. As that same first footnote makes clear, the guidelines may be revised to "reflect significant changes in enforcement policy…or to reflect new learning." But guidelines designed to provide some clarity on how vertical mergers have been and will be reviewed are not the forum for a broad exchange of views on antitrust policy. Those comments are more helpful in FTC hearings, speeches, or enforcement actions that the Commissioners might participate in, not guidelines for practitioners.

Commissioner Slaughter's statement, on the other hand, stays focused on vertical mergers and the issues that she has with these draft guidelines. She and other early commentators raise at least some questions about the current draft that I hope will be addressed in the final version. For instance, the 1984 version of the guidelines included as potential anticompetitive effects from vertical mergers 1) regulatory evasion and 2) the creation of the need for potential entrants to enter at multiple stages of the market. As Commissioner Slaughter points out, the current draft guidelines drop those two and instead focus on 1) foreclosure; 2) raising rivals' costs; and 3) the exchange of competitively sensitive information.

Should we take the absence of the two 1984 harms as an indication that those types of harms are no longer important to the Agencies? Or that they have not been important in recent Agency action, and so did not make this draft, but would still be considered if the correct facts were found? Some other option? While the new guidelines would become too long and unwieldy if they recited and rejected all potential theories of harm, I join Commissioner Slaughter in thinking it would be helpful to include an explanation regarding these particular changes from the prior guidance.

## *Who bears the burden on elimination of double marginalization?*

Finally, both Commissioner Wilson's and Commissioner Slaughter's statements specifically request public comments regarding certain features of the draft guidelines' handling of the elimination of double marginalization ("EDM"). While they raise good questions, I want to focus on a more fundamental question raised by the draft guidelines and a recent speech by Assistant Attorney General Makan Delrahim.

The draft guidelines provide a concise, cogent description of EDM, the usual analysis of it during vertical mergers, and some special factors that might make it less likely to occur. Some commentators have pointed out that EDM gets its own section of the draft guidelines, signaling its importance. I think it even more significant, perhaps, that that separate section is placed in between the sections on unilateral and coordinated competitive effects. Does that placement signal that the analysis of EDM is part of the Agencies' analysis of the overall predicted competitive effects of the merger? That hypothesis also is supported by this statement at the end of the EDM section: "The Agencies will not challenge a merger if the net effect of elimination of double marginalization means that the merger is unlikely to be anticompetitive in any relevant market."

Because the Agencies would have the ultimate burden of showing in court that the effect of the proposed merger "may be substantially to lessen competition, or tend to create a monopoly," it seems to follow that the Agencies would have the burden to factor EDM into the rest of their competitive analysis to show what the potential overall net effect of the merger would be.

Unfortunately, earlier in the EDM section of the draft guidelines, the Agencies state that they "generally rely on the parties to identify and demonstrate whether and how the merger eliminates double marginalization." (emphasis added) Does that statement merely mean that the parties must cooperate with the Agencies and provide relevant information, as required on all points under Hart-Scott-Rodino? Or is it an attempt to shift to the parties the ultimate burden of proving this part of the competitive analysis? That is, is it a signal that, despite the separate section placed in the middle of the discussion of competitive effects analysis, the Agencies are skeptical of EDM and plan to treat it more like a defense as they treat certain cognizable efficiencies?

That latter position is supported by comments by AAG Delrahim in a recent speech: "as the law requires for the advancement of any affirmative defense, the burden is on the parties in a vertical merger to put forward evidence to support and quantify EDM as a defense." So is EDM a defense to an otherwise anticompetitive vertical merger or just part of the overall analysis of competitive effects? Before getting to the pertinent but more detailed questions posed by Commissioners Wilson and Slaughter, these draft guidelines would further their goal of providing clarity by answering that more basic EDM question.

**Despite those concerns, the draft guidelines seem consistent with the antitrust community's consensus today on the proper analysis of vertical mergers. As such, they would seem to be consistent with how the Agencies evaluate such mergers today and so provide helpful guidance to parties considering such a merger. I hope the final version considers all the comments and remains helpful – and is released on a Monday so we can all more easily and intelligently start commenting.**



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# Fruits: Messy Mergers and Muddled Guidelines (Or, “Orange You Glad I Didn’t Say Banana?”)

Eric Fruits — 7 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Eric Fruits (Chief Economist, International Center for Law & Economics and Professor of Economics, Portland State University).*]

Vertical mergers are messy. They’re messy for the merging firms and they’re especially messy for regulators charged with advancing competition without advantaging competitors. Firms rarely undertake a vertical merger with an eye toward monopolizing a market. Nevertheless, competitors and competition authorities excel at conjuring up complex models that reveal potentially harmful consequences stemming from vertical mergers. In their post, Gregory J. Werden and Luke M. Froeb highlight the challenges in evaluating vertical mergers:

> [V]ertical mergers produce anticompetitive effects only through indirect mechanisms with many moving parts, which makes the prediction of competitive effects from vertical mergers more complex and less certain.

There’s a recurring theme throughout this symposium: The current Vertical Merger Guidelines should be updated; the draft Guidelines are a good start, but they raise more questions than they answer. Other symposium posts have hit on the key ups and downs of the draft Guidelines.

**In this post, I use the draft Guidelines’ examples to highlight how messy vertical mergers can be. The draft Guidelines’ examples are meant to clarify the government’s thinking on markets and mergers. In the end, however, they demonstrate the complexity in identifying relevant markets, related products, and the dynamic interaction of competition**. I will focus on two examples provided in the draft Guidelines. Warning: you’re going to read a lot about oranges.

In the following example from the draft Guidelines, the *relevant market* is the wholesale supply of orange juice in region X and Company B's supply of oranges is the *related product*:

> **Example 2**: Company A is a wholesale supplier of orange juice. It seeks to acquire Company B, an owner of orange orchards. The Agencies may consider whether the merger would lessen competition in the wholesale supply of orange juice in region X (the relevant market). The Agencies may identify Company B's supply of oranges as the related product. Company B's oranges are used in fifteen percent of the sales in the relevant market for wholesale supply of orange juice. The Agencies may consider the share of fifteen percent as one indicator of the competitive significance of the related product to participants in the relevant market.

The figure below illustrates one hypothetical structure. Company B supplies an equal amount of oranges to Company A and two other wholesalers, C and D, totalling 15 percent of orange juice sales in region X. Orchards owned by others account for the remaining 85 percent. For the sake of argument, assume all the wholesalers are the same size in which case Company B's orchard would supply 20 percent of the oranges used by wholesalers A, C, and D.

Orange juice sold in a particular region is just one of many uses for oranges. The juice can be sold as fresh liquid, liquid from concentrate, or frozen concentrate. The fruit can be sold as fresh produce or it can be canned, frozen, or processed into marmalade. Many of these products can be sold outside of a particular region and can be sold outside of the United States. This is important in considering the next example from the draft Guidelines.

> **Example 3**: In Example 2, the merged firm may be able to profitably stop supplying oranges (the related product) to rival orange juice suppliers (in the relevant market). The merged firm will lose the margin on the foregone sales of oranges but may benefit from increased sales of orange juice if foreclosed rivals would lose sales, and some of those sales were diverted to the merged firm. If the benefits outweighed the costs, the merged firm would find it profitable to foreclose. If the likely effect of the foreclosure were to substantially lessen competition in the orange juice market, the merger potentially raises significant competitive concerns and may warrant scrutiny.

This is the classic example of raising rivals' costs. Under the standard formulation, the merged firm will produce oranges at the orchard's marginal cost — in theory, the price it pays for oranges would be the same both pre- and post-merger. If orchard B does not sell its oranges to the non-integrated wholesalers C, D, and E, the other orchards will be able to charge a price greater than their marginal cost of production and greater than the pre-merger market price for oranges. The higher price of oranges used by non-integrated wholesalers will then be reflected in higher prices for orange juice sold by the wholesalers.

The merged firm's juice prices will be higher post-merger because its unintegrated rivals' juice prices will be higher, thus increasing the merged firm's profits. The merged firm and unintegrated orchards would be the "winners;" unintegrated wholesalers and consumers would be the "losers." Under a consumer welfare standard the result could be deemed anticompetitive. Under a total welfare standard, anything goes.

**But, the classic example of raising rivals' costs is based on some strong assumptions**. It assumes that, pre-merger, all upstream firms price at marginal cost, which means there is no double marginalization. It assumes all the upstream firm's products are perfectly identical. It assumes unintegrated firms don't respond by integrating themselves. **If one or more of these assumptions is not correct, more complex models — with additional (potentially unprovable) assumptions — must be employed**. What begins as

a seemingly straightforward theoretical example is now a battle of which expert’s models best fit the facts and best predicts the likely outcome.

In the draft Guidelines’ raising rivals’ costs example, it’s assumed the merged firm would refuse to sell oranges to rival downstream wholesalers. However, if rival orchards charge a sufficiently high price, the merged firm would profit from undercutting its rivals’ orange prices, while still charging a price greater than marginal cost. **Thus, it’s not obvious that the merged firm has an incentive to cut off supply to downstream competitors. The extent of the pricing pressure on the merged firm to cheat on itself is an empirical matter that depends on how upstream and downstream firms react, or might react**.

For example, using the figure above, if the merged firm stopped supplying oranges to rival wholesalers, then the merged firm’s orchard would supply 60 percent of the oranges used in the firm’s juice. Although wholesalers C and D would not get oranges from B’s orchards, they could obtain oranges from other orchards that are no longer supplying wholesaler A. In this case, the merged firm’s attempt at foreclosure would have no effect and there would be no harm to competition.

It’s possible the merged firm would divert some or all of its oranges to a “secondary” market, removing those oranges from the juice market. Rather than juicing oranges, the merged firm may decide to sell them as fresh produce; fresh citrus fruits account for 7 percent of Florida’s crop and 75% of California’s. This diversion would lead to a decline in the supply of oranges for juice and the price of this key input would rise.

But, as noted in the Guidelines’ example, this strategy would raise the merged firm’s costs along with its rivals. Moreover, rival orchards can respond to this strategy by diverting their own oranges from “secondary” markets to the juice market, in which case there may be no significant effect on the price of juice oranges. What begins as a seemingly straightforward theoretical example is now a complicated empirical matter. Or worse, it may just be a battle over which expert is the most convincing fortune teller.

**Moreover, the merged firm may have legitimate business reasons for the merger and legitimate business reasons for reducing the supply of oranges to juice wholesalers**. For example “citrus greening,” an incurable bacterial disease, has caused severe damage to Florida’s citrus industry, significantly reducing crop yields. A vertical merger could be one way to reduce supply risks. On the demand side, an increase in the demand for fresh oranges would guide firms to shift from juice and processed markets to the fresh market. What some would see as anticompetitive conduct, others would see as a natural and expected response to price signals.Because of the many alternative uses for oranges, it’s overly simplistic to declare that the supply of orange juice in a specific region is “the” relevant market. Orchards face a myriad of options in selling their products. Misshapen fruit can be juiced fresh or as frozen concentrate; smaller fruit can be canned or jellied. “Perfect” fruit can be sold as fresh produce, juice, canned, or jellied. Vertical integration with a juice wholesaler adds just one factor to the myriad factors affecting how and where an upstream supplier sells its products. **Just as there is no single relevant market, in many cases there is no single related product — a fact that is especially relevant in vertical relationships. Unfortunately the draft Guidelines provide little guidance in these important areas.**




# Pozen: The Missed Opportunity for International Harmonization in the Draft Vertical Merger Guidelines

Sharis Pozen — 7 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Sharis Pozen (Partner, Clifford Chance; former Vice President of Global Competition Law and Policy, GE; former Acting Assistant Attorney General, DOJ Antitrust Division); with Timothy Cornell (Partner, Clifford Chance); Brian Concklin (Counsel, Clifford Chance); and Michael Van Arsdall (Counsel, Clifford Chance).*]

**The draft Vertical Merger Guidelines ("Guidelines") miss a real opportunity to provide businesses with consistent guidance across jurisdictions and to harmonize the international approach to vertical merger review**.

As drafted, the Guidelines indicate the agencies will evaluate market shares and concentration — measured using the same methodology described in the long-standing Horizontal Merger Guidelines — but not use these metrics as a "rigid screen." On that basis the Guidelines establish a "soft" 20 percent threshold, where the U.S. Agencies are "unlikely to challenge a vertical merger" if the merging parties have less than a 20 percent share of the relevant market and the related product is used in less than 20 percent of the relevant market.

**We suggest, instead, that the Guidelines be aligned with those of other jurisdictions, namely the EU non-horizontal merger guidelines** [*for an extended discussion of which, see Bill Kolaasky's symposium post here —ed.*]. The European Commission's guidelines state the European Commission is "unlikely to find concern" with a vertical merger affecting less than 30 percent of the relevant markets and the post-merger HHIs fall below 2000. Among others, Japan and Chile employ a similarly higher bar than the Guidelines. A discrepancy between the U.S. and other international guidelines causes unnecessary uncertainty within the business and legal communities and could lead to inconsistent enforcement outcomes.**In any event, beyond the dangers created by a lack of international harmonization, setting**

**the threshold at 20 percent seems arbitrarily low given the pro-competitive nature of most vertical mergers**. Setting the threshold so low fails to recognize the inherently procompetitive nature of the majority of vertical combinations, and could result in false positives, and undue cost and delay.



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# Sher: Implications of the Draft Vertical Merger Guidelines for Vertical Mergers Involving Technology Start-Ups

Scott Sher — 7 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Scott Sher (Partner, Wilson Sonsini Goodrich & Rosati) and Matthew McDonald (Associate, Wilson Sonsini Goodrich & Rosati).*]

On January 10, 2020, the United States Department of Justice ("DOJ") and the Federal Trade Commission ("FTC") (collectively, "the Agencies") released their joint draft guidelines outlining their "principal analytical techniques, practices and enforcement policy" with respect to vertical mergers ("Draft Guidelines"). **While the Draft Guidelines describe and formalize the Agencies' existing approaches when investigating vertical mergers, they leave several policy questions unanswered. In particular, the Draft Guidelines do not address how the Agencies might approach the issue of acquisition of potential or nascent competitors through vertical mergers**. As many technology mergers are motivated by the desire to enter new industries or add new tools or features to an existing platform (i.e., the Buy-Versus-Build dilemma), the omission leaves a significant hole in the Agencies' enforcement policy agenda, and leaves the tech industry, in particular, without adequate guidance as to how the Agencies may address these issues.

This is notable, given that the Horizontal Merger Guidelines explicitly address potential competition theories of harm (*e.g.*, at § 1 (referencing mergers and acquisitions "involving actual or potential competitors"); § 2 ("The Agencies consider whether the merging firms have been, or likely will become absent the merger, substantial head-to-head competitors."). Indeed, the Agencies have recently challenged several proposed horizontal mergers based on nascent competition theories of harm.

Further, there has been much debate regarding whether increased antitrust scrutiny of vertical acquisitions of nascent competitors, particularly in technology markets, is warranted (*See, e.g.*, Open

Markets Institute, *The Urgent Need for Strong Vertical Merger Guidelines* ("Enforcers should be vigilant toward dominant platforms' acquisitions of seemingly small or marginal firms and be ready to block acquisitions that may be part of a monopoly protection strategy. Dominant firms should not be permitted to expand through vertical acquisitions and cut off budding threats before they have a chance to bloom."); Caroline Holland, *Taking on Big Tech Through Merger Enforcement* ("Vertical mergers that create market power capable of stifling competition could be particularly pernicious when it comes to digital platforms.")).

Thus, further policy guidance from the Agencies on this issue is needed. **As the Agencies formulate guidance, they should take note that vertical mergers involving technology start-ups generally promote efficiency and innovation, and that any potential competitive harm almost always can be addressed with easy-to-implement behavioral remedies**.

## *The agencies' draft vertical merger guidelines*

The Draft Guidelines outline the following principles that the Agencies will apply when analyzing vertical mergers:

- **Market definition**. The Agencies will identify a relevant market and one or more "related products." (§ 2) This is a product that is supplied by the merged firm, is vertically related to the product in the relevant market, and to which access by the merged firm's rivals affects competition in the relevant market. (§ 2)
- **Safe harbor**. Unlike horizontal merger cases, the Agencies cannot rely on changes in concentration in the relevant market as a screen for competitive effects. Instead, the Agencies consider measures of the competitive significance of the related product. (§ 3) The Draft Guidelines propose a safe harbor, stating that the Agencies are unlikely to challenge a vertical merger "where the parties to the merger have a share in the relevant market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market." (§ 3) However, shares exceeding the thresholds, taken alone, do not support an inference that the vertical merger is anticompetitive. (§ 3)
- **Theories of unilateral harm**. Vertical mergers can result in unilateral competitive effects, including raising rivals' costs (charging rivals in the relevant market a higher price for the related product) or foreclosure (refusing to supply rivals with the related product altogether). (§ 5.a) Another potential unilateral effect is access to competitively sensitive information: The combined firm may, through the acquisition, gain access to sensitive business information about its upstream or downstream rivals that was unavailable to it before the merger (for example, a downstream rival of the merged firm may have been a premerger customer of the upstream merging party). (§ 5.b)
- **Theories of coordinated harm**. Vertical mergers can also increase the likelihood of post-merger coordinated interaction. For example, a vertical merger might eliminate or hobble a maverick firm that would otherwise play an important role in limiting anticompetitive coordination. (§ 7)
- **Procompetitive effects**. Vertical mergers can have procompetitive effects, such as the elimination of double marginalization ("EDM"). A merger of vertically related firms can create an incentive for the combined entity to lower prices on the downstream product, because it will capture the additional margins from increased sales on the upstream product. (§ 6) EDM thus may benefit both the merged firm and buyers of the downstream product. (§ 6)
- **Efficiencies**. Vertical mergers have the potential to create cognizable efficiencies; the Agencies will evaluate such efficiencies using the standards set out in the Horizontal Merger Guidelines. (§ 8)

## *Implications for vertical mergers involving nascent start-ups*

At present, the Draft Guidelines do not address theories of nascent or potential competition. To the extent the Agencies provide further guidance regarding the treatment of vertical mergers involving nascent start-ups, they should take note of the following facts:

**First, empirical evidence from strategy literature indicates that technology-related vertical mergers are likely to be efficiency-enhancing**. In a survey of the strategy literature on vertical integration, Professor D. Daniel Sokol observed that vertical acquisitions involving technology start-ups are "largely complementary, combining the strengths of the acquiring firm in process innovation with the product innovation of the target firms." (p. 1372) **The literature shows that larger firms tend to be relatively poor at developing new and improved products outside of their core expertise, but are relatively strong at process innovation (developing new and improved methods of production, distribution, support, and the like)**. (Sokol, p. 1373) Larger firms need acquisitions to help with innovation; acquisition is more efficient than attempting to innovate through internal efforts. (Sokol, p. 1373)

**Second, vertical merger policy towards nascent competitor acquisitions has important implications for the rate of start-up formation, and the innovation that results**. Entrepreneurship in technology markets is motivated by the opportunity for commercialization and exit. (Sokol, p. 1362 ("[T]he purpose of such investment [in start-ups] is to reap the rewards of scaling a venture to exit."))

In recent years, as IPO activity has declined, vertical mergers have become the default method of entrepreneurial exit. (Sokol, p. 1376) Increased vertical merger enforcement against start-up acquisitions thus closes off the primary exit strategy for entrepreneurs. As Prof. Sokol concluded in his study of vertical mergers:

> When antitrust agencies, judges, and legislators limit the possibility of vertical mergers as an exit strategy for start-up firms, it creates risk for innovation and entrepreneurship…. it threatens entrepreneurial exits, particularly for tech companies whose very business model is premised upon vertical mergers for purposes of a liquidity event. (p. 1377)

**Third, to the extent that the vertical acquisition of a start-up raises competitive concerns, a behavioral remedy is usually preferable to a structural one**. As explained above, vertical acquisitions typically result in substantial efficiencies, and these efficiencies are likely to overwhelm any potential competitive harm. Further, a structural remedy is likely infeasible in the case of a start-up acquisition. Thus, behavioral relief is the only way of preserving the deal's efficiencies while remedying the potential competitive harm. (Which the Agencies have recognized, *see* DOJ Antitrust Division, *Policy Guide to Merger Remedies*, p. 20 ("Stand-alone conduct relief is only appropriate when a full-stop prohibition of the merger would sacrifice significant efficiencies and a structural remedy would similarly eliminate such efficiencies or is simply infeasible.")) Appropriate behavioral remedies for vertical acquisitions of start-ups would include firewalls (restricting the flow of competitively sensitive information between the upstream and downstream units of the combined firm) or a fair dealing or non-discrimination remedy (requiring the merging firm to supply an input or grant customer access to competitors in a non-discriminatory way) with clear benchmarks to ensure compliance. *(See Policy Guide to Merger Remedies*, pp. 22-24)

To be sure, some vertical mergers may cause harm to competition, and there should be enforcement when the facts justify it. But vertical mergers involving technology start-ups generally enhance efficiency and promote innovation. **Antitrust's goals of promoting competition and innovation are thus best served by taking a measured approach towards vertical mergers involving technology start-ups**. (Sokol, pp. 1362–63) ("Thus, a general inference that makes vertical acquisitions, particularly in tech, more difficult to approve leads to direct contravention of antitrust's role in promoting competition and innovation.")




# Rybnicek: The Draft Vertical Merger Guidelines Would Do More Harm Than Good

Jan Rybnicek — 7 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Jan Rybnicek (Counsel at Freshfields Bruckhaus Deringer US LLP in Washington, D.C. and Senior Fellow and Adjunct Professor at the Global Antitrust Institute at the Antonin Scalia Law School at George Mason University).*]

In an area where it may seem that agreement is rare, there is near universal agreement on the benefits of withdrawing the DOJ's 1984 Non-Horizontal Merger Guidelines. The 1984 Guidelines do not reflect current agency thinking on vertical mergers and are not relied upon by businesses or practitioners to anticipate how the agencies may review a vertical transaction. The more difficult question is whether the agencies should now replace the 1984 Guidelines and, if so, what the modern guidelines should say.

**There are several important reasons that counsel against issuing new vertical merger guidelines (VMGs)**. Most significantly, we likely are better off without new VMGs because they invariably will (1) send the wrong message to agency staff about the relative importance of vertical merger enforcement compared to other agency priorities, (2) create new sufficient conditions that tend to trigger wasteful investigations and erroneous enforcement actions, and (3) add very little, if anything, to our understanding of when the agencies will or will not pursue an in-depth investigation or enforcement action of a vertical merger.

Unfortunately, these problems are magnified rather than mitigated by the draft VMGs. But it is unlikely at this point that the agencies will hit the brakes and not issue new VMGs. The agencies therefore should make several key changes that would help prevent the final VMGs from causing more harm than good.

## *What is the Purpose of Agency Guidelines?*

Before we can have a meaningful conversation about whether the draft VMGs are good or bad for the world, or how they can be improved to ensure they contribute positively to antitrust law, it is important to identify, and have a shared understanding about, the purpose of guidelines and their potential benefits.

In general, I am supportive of guidelines. In fact, I helped urge the FTC to issue its 2015 Policy Statement articulating the agency's enforcement principles under its Section 5 Unfair Methods of Competition authority. As I have written before, guidelines can be useful if they accomplish two important goals: (1) provide insight and transparency to businesses and practitioners about the agencies' analytical approach to an issue and (2) offer agency staff direction as to agency priorities while cabining the agencies' broad discretion by tethering investigational or enforcement decisions to those guidelines. An additional benefit may be that the guidelines also could prove useful to courts interpreting or applying the antitrust laws.

Transparency is important for the obvious reason that it allows the business community and practitioners to know how the agencies will apply the antitrust laws and thereby allows them to evaluate if a specific merger or business arrangement is likely to receive scrutiny. But guidelines are not only consumed by the public. They also are used by agency staff. As a result, guidelines invariably influence how staff approaches a matter, including whether to open an investigation, how in-depth that investigation is, and whether to recommend an enforcement action. Lastly, for guidelines to be meaningful, they also must accurately reflect agency practice, which requires the agencies' analysis to be tethered to an analytical framework.

As discussed below, there are many reasons to doubt that the draft VMGs can deliver on these goals.

## *Draft VMGs Will Lead to Bad Enforcement Policy While Providing Little Benefit*

**A chief concern with VMGs is that they will inadvertently usher in a new enforcement regime that treats horizontal and vertical mergers as co-equal enforcement priorities despite the mountain of evidence, not to mention simple logic, that mergers among competitors are a significantly greater threat to competition than are vertical mergers**. The draft VMGs exacerbate rather than mitigate this risk by creating a false equivalence between vertical and horizontal merger enforcement and by establishing new minimum conditions that are likely to lead the agencies to pursue wasteful investigations of vertical transactions. And the draft VMGs do all this without meaningfully advancing our understanding of the conditions under which the agencies are likely to pursue investigations and enforcement against vertical mergers.

### 1. No Recognition of the Differences Between Horizontal and Vertical Mergers

**One striking feature of the draft VMGs is that they fail to contextualize vertical mergers in the broader antitrust landscape. As a result, it is easy to walk away from the draft VMGs with the impression that vertical mergers are as likely to lead to anticompetitive harm as are horizontal mergers.** That is a position not supported by the economic evidence or logic. It is of course true that vertical mergers can result in competitive harm; that is not a seriously contested point. But it is important to acknowledge and provide background for why that harm is significantly less likely than in horizontal cases. That difference should inform agency enforcement priorities. Potentially due to this the lack of framing, the draft VMGs tend to speak more about when the agencies *may* identify competitive harm rather than when they *will not*.

The draft VMGs would benefit greatly from a more comprehensive approach to understanding vertical merger transactions. The agencies should add language explaining that, whereas a consensus exists that eliminating a direct competitor always tends to increase the risk of unilateral effects (although often trivially), there is no such consensus that harm will result from the combination of complementary assets. In fact, the current evidence shows such vertical transactions tend to be procompetitive. Absent such language, the VMGs will over time misguidedly focus more agency resources into investigating vertical mergers where there is unlikely to be harm (with inevitably more enforcement errors) and less time on more important priorities, such as pursuing enforcement of anticompetitive horizontal transactions.

### 2. The 20% Safe Harbor Provides No Harbor and Will Become a Sufficient Condition

The draft VMGs attempt to provide businesses with guidance about the types of transactions the agencies *will not* investigate by articulating a market share safe harbor. **But that safe harbor does not (1) appear to be grounded in any evidence, (2) is surprisingly low in comparison to the EU vertical merger guidelines, and (3) is likely to become a sufficient condition to trigger an in-depth investigation or enforcement.**

The draft VMGs state:

> *The Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20%, and the related product is used in less than 20% of the relevant market.*

But in the very next sentence the draft VMGs render the safe harbor virtually meaningless, stating:

> *In some circumstance, mergers with shares below the threshold can give rise to competitive concerns.*

This caveat comes despite the fact that the 20% threshold is low compared to other jurisdictions. Indeed, the EU's guidelines create a 30% safe harbor. Nor is it clear what the basis is for the 20% threshold, either in economics or law. **While it is important for the agencies to remain flexible, too much flexibility will render the draft VMGs meaningless.** The draft VMGs should be less equivocal about the types of mergers that will not receive significant scrutiny and are unlikely to be the subject of enforcement action.

What may be most troubling about the market share safe harbor is the likelihood that it will establish general enforcement norms that did not previously exist. **It is likely that agency staff will soon interpret (despite language stating otherwise) the 20% market share as the *minimum necessary condition* to open an in-depth investigation and to pursue an enforcement action.** We have seen other guidelines' tools have similar effects on agency analysis before (see, GUPPIs). This risk is only exacerbated where the safe harbor is not a true safe harbor that provides businesses with clarity on enforcement priorities.

### 3. Requirements for Proving EDM and Efficiencies Fails to Recognize Vertical Merger Context

The draft VMGs minimize the significant role of EDM and efficiencies in vertical mergers. The agencies frequently take a skeptical approach to efficiencies in the context of horizontal mergers and it is well-known that the hurdle to substantiate efficiencies is difficult, if not impossible, to meet. The draft VMGs oddly continue this skeptical approach by specifically referencing the standards discussed in the horizontal merger guidelines for efficiencies when discussing EDM and vertical merger efficiencies. **The draft VMGs do not recognize that the combination of complementary products is inherently more likely to generate efficiencies than in horizontal mergers between competitors.** The draft VMGs also oddly discuss EDM and efficiencies in separate sections and spend a trivial amount of time on what is the core motivating feature of vertical mergers. Even the discussion of EDM is as much about where there may be exceptions to EDM as it is about making clear the uncontroversial view that EDM is frequent in vertical transactions. Without acknowledging the inherent nature of EDM and efficiencies more generally, the final VMGs will send the wrong message that vertical merger enforcement should be on par with horizontal merger enforcement.

### 4. No New Insights into How Agencies Will Assess Vertical Mergers

Some might argue that the costs associated with the draft VMGs nevertheless are tolerable because the guidelines offer significant benefits that far outweigh their costs. But that is not the case here. The draft VMGs provide no new information about how the agencies will review vertical merger transactions and under what circumstances they are likely to seek enforcement actions. And that is because it is a difficult if not impossible task to identify any such general guiding principles. Indeed, unlike in the context of

horizontal transactions where an increase in market power informs our thinking about the likely competitive effects, greater market power in the context of a vertical transaction that combines complements creates downward pricing pressure that often will dominate any potential competitive harm.

The draft VMGs do what they can, though, which is to describe in general terms several theories of harm. But the benefits from that exercise are modest and do not outweigh the significant risks discussed above. The theories described are neither novel or unknown to the public today. Nor do the draft VMGs explain any significant new thinking on vertical mergers, likely because there has been none that can provide insight into general enforcement principles. The draft VMGs also do not clarify changes to statutory text (because it has not changed) or otherwise clarify judicial rulings or past enforcement actions. As a result, the draft VMGs do not offer sufficient benefits that would outweigh their substantial cost.

### Conclusion

Despite these concerns, it is worth acknowledging the work the FTC and DOJ have put into preparing the draft VMGs. It is no small task to articulate a unified position between the two agencies on an issue such as vertical merger enforcement where so many have such strong views. To the agencies' credit, the VMGs are restrained in not including novel or more adventurous theories of harm. I anticipate the DOJ and FTC will engage with commentators and take the feedback seriously as they work to improve the final VMGs.



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# White: The Missing Market Definition Standard in the Draft Vertical Guidelines

Lawrence White — 7 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Lawrence J. White (Robert Kavesh Professor of Economics, New York University; former Chief Economist, DOJ Antitrust Division).*]

The DOJ/FTC Draft Vertical Merger Guidelines establish a "safe harbor" of a 20% market share for each of the merging parties. But the issue of defining the relevant "market" to which the 20% would apply is not well addressed.

Although reference is made to the market definition paradigm that is offered by the DOJ's and FTC's Horizontal Merger Guidelines ("HMGs"), what is neglected is the following: Under the "unilateral effects" theory of competitive harm of the HMGs, the horizontal merger of two firms that sell differentiated products that are imperfect substitutes could lead to significant price increases if the second-choice product for a significant fraction of each of the merging firms' customers is sold by the partner firm. Such unilateral-effects instances are revealed by examining detailed sales and substitution data with respect to the customers of only the two merging firms.

In such instances, the true "relevant market" is simply the products that are sold by the two firms, and the merger is effectively a "2-to-1" merger. Under these circumstances, any apparently broader market (perhaps based on physical or functional similarities of products) is misleading, and the "market" shares of the merging parties that are based on that broader market are under-representations of the potential for their post-merger exercise of market power.

With a vertical merger, the potential for similar unilateral effects* would have to be captured by examining the detailed sales and substitution patterns of each of the merging firms *with all of their significant horizontal competitors*. This will require a substantial, data-intensive effort. And, of course, if this effort is not undertaken and an erroneously broader market is designated, the 20% "market" share threshold will understate the potential for competitive harm from a proposed vertical merger.

** With a vertical merger, such "unilateral effects" could arise post-merger in two ways: (a) The downstream partner could maintain a higher price, since some of the lost profits from some of the lost sales could be recaptured by the upstream partner's profits on the sales of components to the downstream rivals (which gain some of the lost sales); and (b) the upstream partner could maintain a higher price to the downstream rivals, since some of the latter firms' customers (and the concomitant profits) would be captured by the downstream partner.*



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# Manne & Stout 1: The Illogic of a Contract/Merger Equivalency Assumption in the Assessment of Vertical Mergers

Geoffrey Manne & Kristian Stout — 7 February 2020 — Leave a comment

[***TOTM:*** *The following is part of a symposium by TOTM guests and authors on the 2020 Vertical Merger Guidelines. The entire series of posts is available here.*

*This post is authored by Geoffrey A. Manne (President & Founder, ICLE; Distinguished Fellow, Northwestern University Center on Law, Business, and Economics ); and Kristian Stout (Associate Director, ICLE).*]

As many in the symposium have noted — and as was repeatedly noted during the FTC's Hearings on Competition and Consumer Protection in the 21st Century — there is widespread dissatisfaction with the 1984 Non-Horizontal Merger Guidelines.

Although it is doubtless correct that the 1984 guidelines don't reflect the latest economic knowledge, it is by no means clear that this has actually been a problem — or that a new set of guidelines wouldn't create even greater problems. Indeed, as others have noted in this symposium, **there is a great deal of ambiguity in the proposed guidelines that could lead either to uncertainty as to how the agencies will exercise their discretion, or, more troublingly, could lead courts to take seriously speculative theories of harm**.

We can do little better in expressing our reservations that new guidelines are needed than did the current Chairman of the FTC, Joe Simons, writing on this very blog in a symposium on what became the 2010 Horizontal Merger Guidelines. In a post entitled, *Revisions to the Merger Guidelines: Above All, Do No Harm*, Simons writes:

> My sense is that there is no need to revise the DOJ/FTC Horizontal Merger Guidelines, with one exception…. The current guidelines lay out the general framework quite well and any change in language relative to that framework are likely to create more confusion rather than less. Based on my

> own experience, the business community has had a good sense of how the agencies conduct merger analysis…. If, however, the current administration intends to materially change the way merger analysis is conducted at the agencies, then perhaps greater revision makes more sense. But even then, perhaps the best approach is to try out some of the contemplated changes (*i.e.* in actual investigations) and publicize them in speeches and the like before memorializing them in a document that is likely to have some substantial permanence to it.

Wise words. Unless, of course, "the current [FTC] intends to materially change the way [vertical] merger analysis is conducted." But the draft guidelines don't really appear to portend a substantial change, and in several ways they pretty accurately reflect agency practice.

**What we want to draw attention to, however, is an implicit underpinning of the draft guidelines that we believe the agencies should clearly disavow (or at least explain more clearly the complexity surrounding): the extent and implications of the presumed functional equivalence of vertical integration by contract and by merger — the contract/merger equivalency assumption**.

## *Vertical mergers and their discontents*

The contract/merger equivalency assumption has been gaining traction with antitrust scholars, but it is perhaps most clearly represented in some of Steve Salop's work. Salop generally believes that vertical merger enforcement should be heightened. Among his criticisms of current enforcement is his contention that efficiencies that can be realized by merger can often also be achieved by contract. As he discussed during his keynote presentation at last year's FTC hearing on vertical mergers:

> And, finally, the key policy issue is the issue is not about whether or not there are efficiencies; the issue is whether the efficiencies are merger-specific. As I pointed out before, Coase stressed that you can get vertical integration by contract. Very often, you can achieve the vertical efficiencies if they occur, but with contracts rather than having to merge.

And later, in the discussion following his talk:

> If there is vertical integration by contract… it meant you could get all the efficiencies from vertical integration with a contract. You did not actually need the vertical integration.

Salop thus argues that because the existence of a "contract solution" to firm problems can often generate the same sorts of efficiencies as when firms opt to merge, enforcers and courts should generally adopt a presumption *against* vertical mergers relative to contracting:

> **Coase's door swings both ways**: **Efficiencies often can be achieved by vertical contracts, without the potential anticompetitive harms from merger**.
>
> In that vertical restraints are characterized as "just" vertical integration "by contract," then claimed efficiencies in problematical mergers might be achieved with non-merger contracts that do not raise the same anticompetitive concerns. (emphasis in original)

(Salop isn't alone in drawing such a conclusion, of course; Carl Shapiro, for example, has made a similar point (as have others)).

In our next post we explore the policy errors implicated by this contract/merger equivalency assumption. But **here we want to consider whether it makes logical sense in the first place**.

## *The logic of vertical integration is not commutative*

It is true that, *where contracts are observed*, they are likely as (or more, actually) efficient than merger. But, by the same token, it is also true that where *mergers* are observed they are likely more efficient than contracts. Indeed, the entire reason for integration is efficiency relative to what could be done by contract — this is the essence of the so-called "make-or-buy" decision.

For example, a firm that decides to buy its own warehouse has determined that doing so is more efficient than renting warehouse space. Some of these efficiencies can be measured and quantified (e.g., carrying costs of ownership vs. the cost of rent), but many efficiencies cannot be easily measured or quantified (e.g., layout of the facility or site security). Under the contract/merger equivalency assumption, the benefits of owning a warehouse can be achieved "very often" by renting warehouse space. But the fact that many firms using warehouses own some space and rent some space indicates that the make-or-buy decision is often unique to each firm's idiosyncratic situation. Moreover, the distinctions driving those differences will not always be readily apparent, and whether contracting or integrating is preferable in any given situation may not be inferred from the existence of one or the other elsewhere in the market — or even in the same firm!

**There is no reason to presume in any given situation that the outcome from contracting would be the same as from merging, even where both are notionally feasible. The two are, quite simply, different bargaining environments, each with a different risk and cost allocation; accounting treatment; effect on employees, customers, and investors; tax consequence, etc. Even if the parties accomplished nominally "identical" outcomes, they would not, in fact, be identical**.

Meanwhile, what if the reason for failure to contract, or the reason to prefer merger, has nothing to do with efficiency? What if there were no anticompetitive aim but there were a tax advantage? What if one of the parties just wanted a larger firm in order to satisfy the CEO's ego? That these are not cognizable efficiencies under antitrust law is clear. **But the adoption of a presumption of equivalence between contract and merger would — ironically — entail their incorporation into antitrust law just the same — by virtue of their effective *prohibition* under antitrust law**.

In other words, if the assumption is that contract and merger are equally efficient unless proven otherwise, but the law adopts a suspicion (or, even worse, a presumption) that vertical mergers are anticompetitive which can be rebutted only with highly burdensome evidence of net *efficiency* gain, this effectively deputizes antitrust law to enforce a preconceived notion of "merger appropriateness" that does *not* necessarily turn on efficiencies. There may (or may not) be sensible policy reasons for adopting such a stance, but they aren't *antitrust* reasons.

**More fundamentally, however, while there are surely some situations in which contractual restraints might be able to achieve similar organizational and efficiency gains as a merger, the practical realities of achieving not just greater efficiency, *but a whole host of non-efficiency-related, yet nonetheless valid, goals*, are rarely equivalent between the two**.

It may be that the parties don't know what they don't know to such an extent that a contract would be too costly because it would be too incomplete, for example. But incomplete contracts and ambiguous control and ownership rights aren't (as much of) an issue on an ongoing basis after a merger.

As noted, there is no basis for assuming that the *structure* of a merger and a contract would be identical. In the same way, **there is no basis for assuming that the *knowledge transfer* that would result from a merger would be the same as that which would result from a contract — and in ways that the parties**

**could even specify or reliably calculate in advance**. Knowing that the prospect for knowledge "synergies" would be higher with a merger than a contract might be sufficient to induce the merger outcome. But asked to provide evidence that the parties could not engage in the same conduct via contract, the parties would be unable to do so. The consequence, then, would be the loss of potential gains from closer integration.

At the same time, the cavalier assumption that parties would be able — legally — to enter into an analogous contract in lieu of a merger is problematic, given that it would likely be *precisely* the form of contract (foreclosing downstream or upstream access) that is alleged to create problems with the merger in the first place.

At the FTC hearings last year, Francine LaFontaine highlighted this exact concern:

> I want to reemphasize that there are also rules against vertical restraints in antitrust laws, and so to say that the firms could achieve the mergers outcome by using vertical restraints is kind of putting them in a circular motion where we are telling them you cannot merge because you could do it by contract, and then we say, but these contract terms are not acceptable.

Indeed, legal risk is one of the reasons why a merger might be preferable to a contract, and because the relevant markets here are oligopoly markets, the possibility of impermissible vertical restraints between large firms with significant market share is quite real.

More important, the assumptions underlying the contention that contracts and mergers are functionally equivalent legal devices fails to appreciate the importance of varied institutional environments. Consider that one reason some takeovers are *hostile* is because incumbent managers don't want to merge, and often believe that they are running a company as well as it can be run — that a change of corporate control would not improve efficiency. The same presumptions may also underlie refusals to contract and, even more likely, may explain why, to the other firm, a contract would be ineffective.

**But, while there is no way to contract without bilateral agreement, there *is* a corporate control mechanism to force a takeover. In this institutional environment a merger may be easier to realize than a contract (and that applies even to a *consensual* merger, of course, given the hostile outside option)**. In this case, again, the assumption that contract should be the relevant baseline and the preferred mechanism for coordination is misplaced — even if other firms in the industry are successfully accomplishing the same thing via contract, and even if a contract would be more "efficient" in the abstract.

## *Conclusion*

Properly understood, the choice of whether to contract or merge derives from a host of complicated factors, many of which are difficult to observe and/or quantify. **The contract/merger equivalency assumption — and the species of "least-restrictive alternative" reasoning that would demand onerous efficiency arguments to permit a merger when a contract was notionally possible — too readily glosses over these complications and unjustifiably embraces a relative hostility to vertical mergers at odds with both theory and evidence**.

Rather, as has long been broadly recognized, there can be no legally relevant presumption drawn against a company when it chooses one method of vertical integration over another in the general case. **The agencies should clarify in the draft guidelines that the mere possibility of integration via contract or the inability of merging parties to rigorously describe and quantify efficiencies does not condemn a proposed merger**.




# Manne & Stout 2: Against Incorporating a Contract/Merger Equivalency Assumption in Vertical Merger Guidelines

Geoffrey Manne & Kristian Stout — 7 February 2020 — Leave a comment

In our first post, we discussed the weaknesses of an important theoretical underpinning of efforts to expand vertical merger enforcement (including, possibly, the proposed guidelines): the contract/merger equivalency assumption.

In this post we discuss the implications of that assumption and some of the errors it leads to — including some incorporated into the proposed guidelines.

## *There is no theoretical or empirical justification for more vertical enforcement*

Tim Brennan makes a fantastic and regularly overlooked point in his post: If it's true, as many claim (*see, e.g.*, Steve Salop), that firms can generally realize vertical efficiencies by contracting instead of merging, then it's also true that they can realize *anticompetitive outcomes* the same way. **While efficiencies have to be merger-specific in order to be relevant to the analysis, so too do harms. But where the assumption is that the outcomes of integration can generally be achieved by the "less-restrictive" means of contracting, that would apply as well to any potential harms, thus negating the transaction-specificity required for enforcement**. As Dennis Carlton notes:

> There is a symmetry between an evaluation of the harms and benefits of vertical integration. Each must be merger-specific to matter in an evaluation of the merger's effects…. If transaction costs are low, then vertical integration creates neither benefits nor harms, since everything can be achieved by contract. If transaction costs exist to prevent the achievement of a benefit but not a harm (or vice-versa), then that must be accounted for in a calculation of the overall effect of a vertical merger. (Dennis Carlton, *Transaction Costs and Competition Policy*)

Of course, this also means that those (like us) who believe that it is *not* so easy to accomplish by contract what may be accomplished by merger must also consider the possibility that a proposed merger may be *anticompetitive* because it overcomes an impediment to achieving anticompetitive goals via contract.

There's one important caveat, though: The potential harms that could arise from a vertical merger are the same as those that would be cognizable under Section 2 of the Sherman Act. Indeed, for a vertical merger to cause harm, it must be *expected* to result in conduct that would otherwise be illegal under Section 2. **This means there is always the possibility of a second bite at the apple when it comes to thwarting anticompetitive conduct.**

**The same cannot be said of procompetitive conduct that can arise only through merger if a merger is erroneously prohibited before it even happens**.

Interestingly, Salop himself — the foremost advocate today for enhanced vertical merger enforcement — recognizes the issue raised by Brennan:

> Exclusionary harms and certain efficiency benefits also might be achieved with vertical contracts and agreements without the need for a vertical merger…. It [] might be argued that the absence of premerger exclusionary contracts implies that the merging firms lack the incentive to engage in conduct that would lead to harmful exclusionary effects. But anticompetitive vertical contracts may face the same types of impediments as procompetitive ones, and may also be deterred by potential Section 1 enforcement. Neither of these arguments thus justify a more or less intrusive vertical merger policy generally. Rather, they are factors that should be considered in analyzing individual mergers. (Salop & Culley, *Potential Competitive Effects of Vertical Mergers*)

In the same article, however, Salop also points to the reasons why it should be considered insufficient to leave enforcement to Sections 1 and 2, instead of addressing them at their incipiency under Clayton Section 7:

> While relying solely on post-merger enforcement might have appealing simplicity, it obscures several key facts that favor immediate enforcement under Section 7.

- The benefit of HSR review is to prevent the delays and remedial issues inherent in after-the-fact enforcement….
- There may be severe problems in remedying the concern….
- Section 1 and Section 2 legal standards are more permissive than Section 7 standards….
- The agencies might well argue that anticompetitive post-merger conduct was caused by the merger agreement, so that it would be covered by Section 7….

> All in all, failure to address these kinds of issues in the context of merger review could lead to significant consumer harm and underdeterrence.

The points are (mostly) well-taken. **But they also essentially amount to a preference for more and tougher enforcement against vertical restraints than the judicial interpretations of Sections 1 & 2 currently countenance — a preference, in other words, for the use of Section 7 to bolster enforcement against vertical restraints of *any* sort (whether contractual or structural)**.

The problem with that, as others have pointed out in this symposium (*see, e.g.*, Nuechterlein; Werden & Froeb; Wright, et al.), is that **there's simply no empirical basis for adopting a tougher stance against vertical restraints in the first place**. Over and over again the empirical research shows that vertical restraints and vertical mergers are unlikely to cause anticompetitive harm:

> In reviewing this literature, two features immediately stand out: First, **there is a paucity of support for the proposition that vertical restraints/vertical integration are likely to harm consumers**. . . . Second, a far greater number of studies found that **the use of vertical restraints in the particular context studied improved welfare unambiguously**. (Cooper, et al, *Vertical Restrictions and Antitrust Policy: What About the Evidence?*)
>
> [W]e did not have a particular conclusion in mind when we began to collect the evidence, and we… are therefore somewhat surprised at what the weight of the evidence is telling us. It says that, **under most circumstances, profit-maximizing, vertical-integration decisions are efficient, not just from the firms' but also from the consumers' points of view**…. We therefore conclude that, faced with a vertical arrangement, the burden of evidence should be placed on competition authorities to demonstrate that that arrangement is harmful before the practice is attacked. (Francine Lafontaine & Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence*)
>
> [Table 1 in this paper] indicates that **voluntarily adopted restraints are associated with lower costs, greater consumption, higher stock returns, and better chances of survival**. (Daniel O'Brien, *The Antitrust Treatment of Vertical Restraint: Beyond the Beyond the Possibility Theorems*)
>
> In sum, these papers from 2009-2018 continue to support the conclusions from Lafontaine & Slade (2007) and Cooper et al. (2005) that **consumers mostly benefit from vertical integration**. While vertical integration can certainly foreclose rivals in theory, there is only limited empirical evidence supporting that finding in real markets. (GAI Comment on Vertical Mergers)

To the extent that the proposed guidelines countenance heightened enforcement relative to the status quo, they fall prey to the same defect. And while it is unclear from the fairly terse guidelines whether this is animating them, **the removal of language present in the 1984 Non-Horizontal Merger Guidelines acknowledging the relative lack of harm from vertical mergers ("[a]lthough non-horizontal mergers are less likely than horizontal mergers to create competitive problems…") is concerning**.

## *The shortcomings of orthodox economics and static formal analysis*

There is also a further reason to think that vertical merger enforcement may be more likely to thwart procompetitive than anticompetitive arrangements relative to the status quo ante (i.e., where arrangements among vertical firms are by contract): **Our lack of knowledge about the effects of market structure and firm organization on innovation and dynamic competition, and the relative hostility to nonstandard contracting, including vertical integration**:

> [T]he literature addressing how market structure affects innovation (and vice versa) in the end reveals an ambiguous relationship in which factors unrelated to competition play an important role. (Katz & Shelanski, *Mergers and Innovation*)

The fixation on the equivalency of the form of vertical integration (i.e., merger versus contract) is likely to lead enforcers to focus on static price and cost effects, and miss the dynamic organizational and informational effects that lead to unexpected, increased innovation across and within firms.

In the hands of Oliver Williamson, this means that understanding firms in the real world entails taking an organization theory approach, in contrast to the "orthodox" economic perspective:

> The lens of contract approach to the study of economic organization is partly complementary but also partly rival to the orthodox [neoclassical economic] lens of choice. Specifically, whereas the latter focuses on simple market exchange, the lens of contract is predominantly concerned with the complex contracts. **Among the major differences is that non-standard and unfamiliar contractual practices and organizational structures that orthodoxy interprets as manifestations of monopoly are often perceived to serve economizing purposes under the lens of contract**. A major reason for these and other differences is that orthodoxy is dismissive of organization theory whereas organization theory provides conceptual foundations for the lens of contract. (emphasis added)

**We are more likely to miss it when mergers *solve* market inefficiencies, and more likely to see it when they impose static costs — even if the apparent costs actually represent a move from less efficient contractual arrangements to more efficient integration**.

> The competition that takes place in the real world and between various groups ultimately depends upon the institution of private contracts, many of which, including the firm itself, are nonstandard. Innovation includes the discovery of new organizational forms and the application of old forms to new contexts. Such contracts prevent or attenuate market failure, moving the market toward what economists would deem a more competitive result. Indeed, as Professor Coase pointed out, many markets deemed "perfectly competitive" are in fact the end result of complex contracts limiting rivalry between competitors. This contractual competition cannot produce perfect results — no human institution ever can. Nonetheless, the result is superior to that which would obtain in a (real) world without nonstandard contracting. These contracts do not depend upon the creation or enhancement of market power and thus do not produce the evils against which antitrust law is directed. (Alan Meese, *Price Theory Competition & the Rule of Reason*)

Or, as Oliver Williamson more succinctly puts it:

> [There is a] rebuttable presumption that nonstandard forms of contracting have efficiency purposes. (Oliver Williamson, The Economic Institutions of Capitalism)

## *The pinched focus of the guidelines on narrow market definition misses the bigger picture of dynamic competition over time*

The proposed guidelines (and the theories of harm undergirding them) focus upon indicia of market power that may not be accurate if assessed in more realistic markets or over more relevant timeframes, and, if applied too literally, may bias enforcement against mergers with dynamic-innovation benefits but static-competition costs.

**Similarly, the proposed guidelines' enumeration of potential efficiencies doesn't really begin to cover the categories implicated by the organization of enterprise around dynamic considerations**.

The proposed guidelines' efficiencies section notes that:

> Vertical mergers bring together assets used at different levels in the supply chain to make a final product. A single firm able to coordinate how these assets are used may be able **to streamline production, inventory management, or distribution, or create innovative products in ways that would have been hard to achieve though arm's length contracts**. (emphasis added)

But it is not clear than any of these categories encompasses organizational decisions made to facilitate the coordination of production and commercialization when they are dependent upon intangible assets.

As Thomas Jorde and David Teece write:

> For innovations to be commercialized, the economic system must somehow assemble all the relevant complementary assets and create a dynamically-efficient interactive system of learning and information exchange. The necessary complementary assets can conceivably be assembled by either administrative or market processes, as when the innovator simply licenses the technology to firms that already own or are willing to create the relevant assets. These organizational choices have received scant attention in the context of innovation. **Indeed, the serial model relies on an implicit belief that arm's-length contracts between unaffiliated firms in the vertical chain from research to customer will suffice to commercialize technology. In particular, there has been little consideration of how complex contractual arrangements among firms can assist commercialization — that is, translating R&D capability into profitable new products and processes**….
>
> * * *
>
> **But in reality, the market for know-how is riddled with imperfections. Simple unilateral contracts where technology is sold for cash are unlikely to be efficient. Complex bilateral and multilateral contracts, internal organization, or various hybrid structures are often required to shore up obvious market failures and create procompetitive efficiencies**. (Jorde & Teece, *Rule of Reason Analysis of Horizontal Arrangements: Agreements Designed to Advance Innovation and Commercialize Technology*) (emphasis added)

When IP protection for a given set of valuable pieces of "know-how" is strong — easily defendable, unique patents, for example — firms can rely on property rights to efficiently contract with vertical buyers and sellers. But in cases where the valuable "know how" is less easily defended as IP — e.g. business process innovation, managerial experience, distributed knowledge, corporate culture, and the like — the ability to partially vertically integrate through contract becomes more difficult, if not impossible.

Perhaps employing these assets is part of what is meant in the draft guidelines by "streamline." But the very mention of innovation only in the technological context of *product* innovation is at least some indication that *organizational* innovation is not clearly contemplated.

This is a significant lacuna. **The impact of each organizational form on knowledge transfers creates a particularly strong division between integration and contract**. As Enghin Atalay, Ali Hortaçsu & Chad Syverson point out:

> That vertical integration is often about transfers of intangible inputs rather than physical ones may seem unusual at first glance. However, as observed by Arrow (1975) and Teece (1982), **it is precisely in the transfer of nonphysical knowledge inputs that the market, with its associated contractual framework, is most likely to fail to be a viable substitute for the firm**. Moreover, many theories of the firm, including the four "elemental" theories as identified by Gibbons (2005), do not explicitly invoke physical input transfers in their explanations for vertical integration. (Enghin Atalay, et al., *Vertical Integration and Input Flows*) (emphasis added)

There is a large economics and organization theory literature discussing how organizations are structured with respect to these sorts of intangible assets. And the upshot is that, while **we start — not end, as some would have it — with the Coasian insight that firm boundaries are necessarily a function of production processes and not a hard limit, we quickly come to realize that it is emphatically not the case that integration-via-contract and integration-via-merger are always, or perhaps even often, viable substitutes**.

## *Conclusion*

**The contract/merger equivalency assumption, coupled with a "least-restrictive alternative" logic that favors contract over merger, puts a thumb on the scale against vertical mergers. While the proposed guidelines as currently drafted do not necessarily portend the inflexible, formalistic application of this logic, they offer little to guide enforcers or courts away from the assumption in the important (and perhaps numerous) cases where it is unwarranted**.



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