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Questions Raised By The Proposed Vertical Merger Guidelines

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In January of this year, the U.S. Department of Justice and the Federal Trade Commission released the first joint draft vertical merger guidelines in the agencies' history, and the first update to the DOJ's nonhorizontal merger guidance since 1984.

In the public comment period that followed, 74 comments were submitted by a range of authors, from economists and antitrust lawyers to consumer and small business advocacy groups. On March 11, the DOJ held a workshop with antitrust practitioners to discuss the issues that arose in the comments.

Both the written comments and discussions at the workshop generally applaud the draft guidelines as an improvement over the 1984 DOJ nonhorizontal guidelines. However, commenters and workshop participants also suggest that changes should be made, ranging from minor revisions to major overhauls in the framework of the guidelines.

Although both the written comments and the discussions at the workshop range widely in subject matter and viewpoints, some topics emerge as particularly significant — with a few areas of agreement and other areas of strong disagreement.

For example, comments broadly agree that the guidelines need more examples to demonstrate how they would be applied in practice. On the other hand, comments disagree on important fundamental points, such as whether there should be a presumption of pro-competitive effects in vertical mergers.

Overall, the written comments and workshop discussions show that practitioners want more concrete guidance than what is currently in the draft guidelines. There is, however, little consensus over how much weight to give theories of harm, empirical evidence or potential consumer benefits. A further lack of consensus exists over the guidelines' scope and whether it should be limited to traditional supply-chain relationships.

This uncertainty reflects the fact that nonhorizontal relationships are inherently more complex than horizontal relationships. There are more ways that harm could occur, but also more ways that benefits could materialize.

The agencies face a trade-off between bringing additional clarity for practitioners by making guidance more inclusive and specific, and retaining the flexibility from a more general example-based approach that does not attempt to capture all relevant issues.

Should Vertical Mergers Be Presumed to Be Pro-Competitive?

The proposed guidelines recognize ways in which vertical mergers can be pro-competitive, but fall short of stating whether vertical mergers should be presumed pro-competitive.

Commenters and workshop participants disagree on whether the empirical evidence on past vertical mergers supports a pro-competitive presumption, whether the theoretical basis for pro-competitive effects is strong enough to create a presumption, and whether pro-competitive effects could be achieved contractually without a merger.

Comments disagree on the empirical evidence even though they considered the same empirical studies. Several comments argue that pro-competitive effects could be presumed because studies of past vertical mergers found, on balance, that they led more often to consumer benefits than harms. Others contend the empirical evidence is not sufficiently strong to justify a presumption. Economists generally do not believe the evidence is strong enough to justify a pro-competitive presumption, while attorneys are more mixed.

Opinions are also split on whether the agencies should presume the elimination of double marginalization in vertical mergers. EDM can occur in a supply chain when an upstream firm with market power merges with a downstream firm and eliminates the upstream margin, allowing the downstream firm to lower prices and attract higher demand.

However, as some comments point out, EDM is a theoretical result that in its most common form relies on an assumption of linear pricing in contracts. More general pricing structures could achieve the efficiency without a merger. Further, even if double marginalization occurred premerger, it is not automatically the case that the merger would eliminate it in practice (e.g., if the technology of the downstream firm is specialized to use the inputs of a rival upstream firm).

The point that outcomes may be achievable by contract extends more generally to other efficiencies and leads some commenters to argue that the agencies should perform case-specific analysis to evaluate the relevance of contractual solutions.

Proponents of including a presumption of pro-competitive effects (and EDM in particular) argue that, while contracts can theoretically solve vertical coordination problems, they are often infeasible in practice, and mergers may occur specifically when contracts fail to resolve the alignment problems. Several state attorneys general proposed that the parties prove EDM, so there may also be questions about whether states will follow federal guidance or take their own paths.[1]

The presumption that a merger is pro-competitive or anti-competitive has a considerable impact on what merging parties can expect from the agencies, so this is a likely point of considerable contention as the comments move forward. The agencies need to decide, in particular, how much credence they give to the likelihood of EDM and to contracting as a potential way of achieving the benefits intended through vertical merger.

Types of Relationships

The draft guidelines define vertical mergers as taking place in a supply-chain relationship, with an upstream firm supplying inputs to a downstream firm. This may technically exclude mergers involving complementary products, such as mergers between hospitals and physician groups.

Comments and workshop participants, however, disagree about what types of relationships the guidelines should cover. Some argue that the guidelines should make the supply-chain relationship even more explicit, while others contend that the guidelines could be extended to address complementary product mergers.

In its comment, the American Bar Association's Antitrust Law Section states that the guidelines should explain whether they apply to upstream-downstream relationships or whether they also contemplate mergers of firms not strictly adjacent in a linear supply chain.[2] Several attorneys on the first panel at the DOJ's workshop elaborated on these questions, and argued that the guidelines should favor "upstream" and "downstream" over the less well-understood "relevant market" and "related product" approach. Such language would clarify that the guidelines are limited to supply-chain-type relationships and do not contemplate conglomerate, complementary, or other types of mergers.

Few economists share this view. Several comments point out that complementary product mergers have similar characteristics to vertical mergers and that the guidelines can apply to these mergers, regardless of whether this is explicitly stated. In particular, the Office of Economics and Analytics at the Federal Communications Commission states that the guidelines are potentially applicable to a wider range of relationships, including complementary relationships.[3] It is possible that the agencies could review complementary products mergers in a similar manner to that laid out under the guidelines, even if the guidelines do not explicitly encompass such mergers.

Several comments, as well as panel participants at the DOJ's workshop, point out that firms can be more than two-dimensional, and "horizontal" and "vertical" are not sufficient to describe all issues that can come up in mergers of integrated firms. Mergers can have horizontal, vertical, and complementary aspects, and the guidelines may not be sufficient to address the potential issues that could arise in a complex merger.

Given the potential for vertical, horizontal and complementary issues to arise in many transactions, the agencies may face a difficult decision regarding whether to expand the guidelines or retain their supply-chain phrasing.

Unilateral Effects — Raising Rivals' Costs and Foreclosure

The draft guidelines describe two theories of unilateral harm: raising rivals' costs (or foreclosure), and access to rivals' competitively sensitive information. They focus primarily on the former, where the merger "allow[s] 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."[4]

Some comments note that vertical harm can take place through pathways distinct from raising rivals' costs and that are currently omitted in the guidelines. Other theories of harm mentioned include regulatory evasion, two-stage entry (the need for new entrants to enter two markets at once), and elimination of potential competition.

Regarding raising rivals' costs, several comments note that the guidelines should be clearer that vertical harm takes place in a manner different from horizontal harm. Conversely, other submissions argue that differences in competitive effects between vertical and horizontal mergers may be overemphasized, and encourage the agencies to stress that even for vertical mergers the competitive concern is still essentially horizontal: a reduction in competition in one market.

Several comments argue that raising-rivals'-costs effects in vertical mergers can occur in more varied ways than unilateral effects in horizontal mergers. This also means that the toolkit for evaluating competitive effects in vertical mergers is less standard, and case-specific analysis will typically be required.

The agencies face a decision about how to reflect the variety of potential theories of harm in the guidelines. Including a more specific discussion of these theories would add clarity, but may fail to capture the full range of possible competitive harms.

The Usefulness of a Safe Harbor

One of the clearest divides in opinion emerged in relation to the value of retaining a safe harbor. The draft guidelines indicate 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."[5]

Among others, the Canadian and the American Bar Association Antitrust Law Sections favor retaining the safe harbor, but with higher thresholds of perhaps 30% or 40% of the market.[6] In contrast, other comments reject a safe harbor based on market shares which, they explain, is not supported by economic theory. Some argue that the 20% threshold is arbitrary and could result in under-enforcement.

Two submissions argue that a superior (albeit still imperfect) safe harbor would be based on changes in concentration levels rather than share measures.[7] Several push to replace the threshold approach with presumptions based on features of market structure. Notably, some comments ask for somewhat industry-targeted presumptions — the most common one being a presumption for acquisitions by dominant platforms.

If a safe harbor is to be included, many desire clarification of the use-of-the-related-product condition. Several point out it could have various interpretations; some provide examples of how the safe harbor could produce false positives if not properly defined.

Finally, several attorneys, along with one comment from a former DOJ economist and academic economist, call for the guidelines to introduce more certainty that the safe harbors will be binding, arguing that an approach so heavily caveated would not be useful or provide any policy certainty.[8]

Other comments clearly oppose including a safe harbor in the guidelines, but recognize that in practice the agencies will likely follow precedent and not challenge mergers below the thresholds.

An Overarching Framework for the Guidelines

Many comments propose that the guidelines would benefit from a clearer discussion of the basic principles that the agencies will apply to evaluate theories of harm.

For example, some argue that the distinction between the ability to influence competition and incentive to do so should be more explicit, and that the role of input substitution in determining the ability of the merged entity to influence competition should be clearly explained (the concept of input substitution is entirely absent from the draft guidelines).

Two comments point out that, in contrast to the horizontal merger guidelines, the proposed vertical merger guidelines lack an overarching framework.[9] Such a framework would bring together the various elements required to test for different theories of harm and pro-competitive effects.

While recognizing that the increased variety of effects and fact patterns in vertical mergers may call for a less specific framework than the one used in horizontal merger assessments, developing an overarching framework could prove helpful by clarifying what, despite all the variety, is common to vertical mergers and by providing a clear road map for the analysis that practitioners could refer to.

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[1] Xavier Becerra et al., "Public Comments of 28 State Attorneys General on Draft Vertical Merger Guidelines," February 26, 2020, pp. 21–23. All comments cited in this article are available at https://www.ftc.gov/policy/public-comments/draft-vertical-merger-guidelines.

[2] American Bar Association Antitrust Law Section, "Comments of the American Bar Association Antitrust Law Section on the U.S. Antitrust Agencies' Draft Vertical Merger Guidelines," February 22, 2020, p. 12.

[3] Giulia McHenry et al., "Letter to Joseph J. Simons, Ian R. Conner, and Andrew Sweeting," Federal Communications Commission, March 2, 2020.

[4] U.S. Department of Justice and the Federal Trade Commission, "Draft Vertical Merger Guidelines," Released for Public Comment on January 10, 2020 ("Draft Vertical Merger Guidelines"), p. 4, available at https://www.justice.gov/opa/press-release/file/1233741/download.

[5] Draft Vertical Merger Guidelines, p. 3.

[6] American Bar Association Antitrust Law Section, "Comments of the American Bar Association Antitrust Law Section on the U.S. Antitrust Agencies' Draft Vertical Merger Guidelines," February 22, 2020, pp. 5, 9–10; Canadian Bar Association Competition Law Section, "Draft 2020 Vertical Merger Guidelines," February 26, 2020, pp. 2–3.

[7] Jonathan Baker, Nancy Rose, Steven Salop, and Fiona Scott Morton, "Recommendations and Comments on the Draft Vertical Merger Guidelines," February 24, 2020; Serge Moresi and Steven Salop,"Quantifying the Increase in 'Effective Concentration' from Vertical Mergers That Raise Input Foreclosure Concerns: Comment on the Draft Vertical Merger Guidelines," February 24, 2020.

[8] Gregory Werden and Luke M. Froeb, "Comments on Proposed Vertical Merger Guidelines," undated.

[9] Kostis Hatzitaskos, W. Robert Majure, Ana McDowall, and Aviv Nevo, "Comments on the January 2020 Draft Vertical Merger Guidelines," February 19, 2020; Carl Shapiro, "Comment on DOJ/FTC Draft Vertical Merger Guidelines," March 3, 2020.