ALERT MEMORANDUM

US Agencies Release Revised Vertical Merger Guidelines for Public Comment

January 17, 2020

On January 10, 2020, the U.S. Department of Justice and Federal Trade Commission (the "Agencies") released their long-awaited draft Vertical Merger Guidelines for public comment. The draft Guidelines largely reflect the Agencies' current approach and do not appear to represent any meaningful change in enforcement posture or policy. They would replace the existing 1984 Non-Horizontal Merger Guidelines, which were both out-of-date and somewhat misleading. They purport to establish a quasi-safe harbor of 20% share in the upstream and downstream markets, which, because it would be considerably lower than most vertical merger challenges in the past, as well as the comparable 30% share in the European Commission's guidance, is not expected to be a meaningful benchmark in practice.

In connection with the DOJ's and FTC's enforcement of Section 7 of the Clayton Act, which prohibits mergers that may substantially lessen competition, the Agencies periodically publish official guidance explaining their approach to merger review. Published guidelines serve several purposes: (1) providing the public (including practitioners) with transparency about how the Agencies analyse cases; (2) explaining complicated economic concepts to courts outside the context of the advocacy of any particular case; and (3) helping Agency staff to be efficient and rigorous by ensuring that they stick to well-supported theories of harm. The 1984 Guidelines have long been out of step with agency practice and the bar has been advocating for revisions for some time.[1] The new draft Guidelines are a step in the right direction, but fall short of the detail needed to provide comprehensive guidance. Because the Agencies have issued these Guidelines for public comment, practitioners and the general public will have an opportunity to contribute before new Vertical Merger Guidelines are finalized.

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[1] *See, e.g.*, Steven C. Salop and Daniel P. Culley, *Revising the U.S. Vertical Merger Guidelines: Policy Issues and an Interim Guide for Practitioners*, 4(1) J. ANTITRUST ENFORCEMENT 1 (2015).

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Vertical Mergers: Theories of Harm and Efficiencies

A vertical merger combines firms that do not compete with each other, but rather operate at different levels of a single supply chain. Conventionally, many in the bar and at the Agencies, as well as antitrust economists, have believed vertical mergers to be less likely to harm competition than mergers between competitors (horizontal mergers), and enforcement against vertical mergers has therefore been relatively less vigorous. Nevertheless, vertical mergers may lead to a number of competitive concerns, a few of the most common of which are described below:

— **Unilateral effects**

- A firm that purchases a supplier of a critical input to its rivals may be able to profitably raise the price of that input to its rivals or cut those rivals off from the supply of the input entirely ("foreclosure"). This is because, in response to that increase in input prices or lack of input supply, the rivals may increase their downstream prices or restrict their downstream sales, and some of the business the rivals lose as a result may be "re-captured" by the downstream portion of the vertically integrated firm. Whether it will be profitable for the firm to pursue this strategy depends on whether the rivals have alternatives for the input and whether the firm expects that it will re-capture a sufficient amount of the business its rival loses to outweigh the profits lost through decreased sales to the rival.
- Other theories of harm arising from unilateral effects of a vertical merger include denying rivals scale by cutting off their access to customers, using access to information about downstream rivals' future sales to dissuade them from making competitive moves, or raising barriers to entry by forcing new entrants to simultaneously enter both the upstream and downstream markets.

— **Coordinated effects**

- A firm that purchases a supplier or customer may gain access to information held by that supplier or customer about the firm's competitors. This visibility into rivals' sales might allow the firms to establish an agreement without express communication (*e.g.*, coordinating prices) and subsequently more effectively discipline rivals that do not follow the coordinated agreement.

— **Efficiencies**

- Vertical mergers can result in a particular kind of efficiency called "eliminating double marginalization." Pre-merger, if a firm that sells a product is considering whether to lower its price in order to increase its volume of sales, it will only take into account the profits it would make on extra sales of its own product, and it will not consider the extra profits that its upstream supplier will also make when the supplier sells more inputs to the downstream firm. After the downstream firm and its upstream supplier merge, the combined firm would care about profits in *both* markets, so the fact that the lower price it is considering in the downstream market may lead to additional profits in both markets means that, post-merger, it will have a greater incentive to lower prices in the downstream market, to the benefit of both the firm and of customers.
- While there may be ways for firms to eliminate double marginalization without a merger, for example using contracts with complex price schedules or volume targets, there are good reasons to think that eliminating double marginalization is less speculative than other kinds of efficiencies—including those that may result from horizontal mergers.

Unlike horizontal cases, whether a particular vertical theory of harm holds in a given case tends to be very sensitive to the exact conditions of the market in question. A fact that might be anticompetitive in one context may, given different market conditions, be

procompetitive in another. For example, if an input supplier commands high margins, that may signal that it has significant market power. That suggests rivals may be dependent on the input, but it also suggests that the scope for eliminating double marginalization may be large. It can therefore be difficult to determine the net effect of the fact of high margins without detailed economic modeling.

What the Draft Guidelines Say

The draft Guidelines lay out the Agencies' approach to market definition, address the importance of market structure, describe how the Agencies will address evidence of adverse competitive effects, set forth a number of theories of harm to competition (both unilateral effects and coordinated effects), and describe potential efficiencies including elimination of double marginalization.

— **Market Definition**: The draft Guidelines continue the Agencies' approach to defining relevant markets as set forth in the Agencies' Horizontal Merger Guidelines. The draft Guidelines introduce a new concept of "related product." A related product is one that is situated upstream or downstream from the relevant market and is provided by the other merging party, and might include such things as an input, a means of distribution, or access to a set of customers. The draft Guidelines do not explain how the concept of "related product" is intended to relate to a relevant antitrust market.

— **Market Structure**: The draft Guidelines do not contain a presumption of legality for vertical mergers, as some commentators have advocated, but nor do they contain thresholds for a presumption of illegality, as others have suggested. They do contain, however, a 20% "safe harbor": the Agencies have announced that they are "unlikely to challenge" a merger that combines a company with less than 20% share in a downstream market with a company with less than 20% in the upstream market for supply of an input used in that downstream market. Note, however, that while the Agencies may be "unlikely" to challenge such mergers, they may still choose to do so if other facts suggest harm notwithstanding the low shares. The draft Guidelines also state more generally that the Agencies may use market shares and market structure in assessing the likely effects of a vertical merger.

— **Evidence**: The types and sources of evidence the Agencies will consider in assessing the impact of a vertical merger are similar to those considered in the horizontal merger context, and the draft Guidelines largely incorporate by reference the Horizontal Merger Guidelines on this point. The draft Guidelines also note that pre-existing contractual relationships may be particularly relevant in the vertical merger context.

— **Harm**: The draft Guidelines describe unilateral and coordinated theories of harm similar to those described in the section above, focused primarily on input foreclosure. The draft Guidelines state that where possible the Agencies may use available data to construct merger simulations to predict the expected impact of a vertical merger, noting in particular that there is no need to define a market under such an approach.

— **Efficiencies**: As described above, elimination of double marginalization may occur through a vertical merger when an integrated company taking into account both upstream and downstream revenues sets a lower profit-maximizing price than it would have set but-for the vertical integration. The draft Guidelines note that the Agencies may take a simple netting approach with respect to pressure to increase prices to rivals and downward pressure from elimination of double marginalization: "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." In addition to elimination of double marginalization, the Agencies also state that they will consider further efficiencies that may arise through vertical mergers, such as streamlined production, inventory management, or distribution.

Statements of FTC Commissioners

Commissioners Rohit Chopra, Rebecca Slaughter, and Christine Wilson of the Federal Trade Commission issued statements with the release of the draft Guidelines.

— **Commissioner Chopra**: Commissioner Chopra abstained from voting to release the draft Guidelines for public comment. His statement reflects a view that the draft Guidelines are overly reliant on quantitative models, with insufficient rooting in past experience with completed vertical mergers. The comment also states that the draft Guidelines take an overly narrow approach to the ways in which vertical mergers might harm competition in the modern economy.

— **Commissioner Slaughter**: Commissioner Slaughter, who also abstained from voting to release the draft Guidelines for public comment, wrote to note her concern with the inclusion of a safe harbor, that the draft Guidelines had not properly captured the low incipiency standard of the Clayton Act, and that she would have preferred that the draft Guidelines mention the additional theories of harm of elimination of potential entry by a firm into a vertically adjacent market and regulatory evasion.

— **Commissioner Wilson**: Commissioner Wilson's brief concurring statement noted several questions for further consideration: whether the Guidelines should recognize that elimination of double marginalization may be very difficult to achieve by contract, whether merger-specificity should be considered for both efficiencies and for the potential to raise input costs to rivals, whether a more definitive safe harbor should be established, whether upstream and downstream markets should be defined instead of the draft Guidelines' approach of defining a related product, and what magnitude of anticompetitive effects should be viewed as *de minimis*.

Commentary

Views on the appropriate level of vertical merger enforcement are strongly divided; the draft Guidelines take a middle road

Even more than for horizontal mergers, practitioners and commentators are sharply divided on the effects of vertical mergers. On the one hand are those that take the position that vertical mergers are almost never harmful and bring added efficiency to the market through vertical integration. Others believe that the prevailing views of the first group have led to lax enforcement against vertical mergers that have a significant potential to harm competition, and that this type of enforcement should be dramatically increased.

The draft Guidelines take a relatively middle-of-the-road approach, in particular declining to create a presumption of legality for vertical mergers, something many in the bar had advocated for. Nor do the draft Guidelines take a particularly aggressive view of the effects of vertical mergers, with their discussion of elimination of double marginalization in particular suggesting that the Agencies would tend to view this efficiency as particularly credible and often tends to lead to a net procompetitive effect.

The 20% safe harbor proposed by the draft Guidelines is lower than the comparable standard in the European Commission's Non-Horizontal Merger Guidelines, where 30% is used. There is very little academic research on how market shares relate to harm in vertical mergers, and the Agencies do not provide any explanation for choosing these thresholds. In practice, the Agencies do not typically bring vertical cases unless either market shares are far above these levels or inputs are highly differentiated from one another.

The draft Guidelines require a showing of harm to downstream customers

The draft Guidelines also appear to implicitly resolve the important policy question of whether it is enough in order to establish the illegality of a merger to prove that the combined firm would raise the price to or withhold an input from its rivals, or whether one must instead go further to establish that downstream

customers would be injured. Because certain examples given in the draft Guidelines discuss harm to the downstream customer, the draft Guidelines seem to suggest that they will follow the latter approach. By adding an additional element to proving a merger is anticompetitive, this may temper aggressive enforcement.

It is unclear what the agencies intend by creating the separate concept of a "related product" from a relevant antitrust market

The draft Guidelines introduce the concept of a "related product" to describe the particular product that is vertically related to the relevant market (*e.g.*, if the relevant market is automobiles, a related product might be steel used in their construction or dealerships through which they are sold). The alternative approach the Agencies could have taken, which perhaps would have been the more conventional choice as it would not introduce new terminology, would be to simply define a second market that is upstream or downstream of the first. While Commissioner Wilson in her statement characterizes the approach taken by the draft Guidelines as a "looser requirement," it is not immediately obvious what difference this distinction is intended to have.

The draft Guidelines miss important details needed to guide the bar, the courts, and the Agencies' staffs

The draft Guidelines span only a relatively short nine pages and so are also notable for what they do not say.

The draft Guidelines contain minimal detail elaborating on how the theories they describe work in practice. For example, the Agencies could have used the draft Guidelines as an opportunity to explain how a bargaining leverage theory of harm works, as such a theory was recently rejected by the District Court in the AT&T/Time Warner case.

In that case, the Department of Justice alleged that by pairing Time Warner's content such as HBO with AT&T's DirecTV distribution platform, Time Warner would have increased bargaining power when negotiating with distributors because Time Warner could more credibly threaten to "blackout" its content with rival distributors, knowing that this would cause the rival to lose certain customers that highly value Time Warner content and that some of these lost customers would be profitably re-captured by AT&T.[2] Importantly, DOJ argued that blackouts—which are relatively rare and painful to both parties—did not actually have to occur for the merged company's bargaining power to increase. The District Court ultimately ruled against DOJ, finding this theory of harm unsupported by the evidence, and expressing skepticism that the theory was workable at all.

Although the draft Guidelines reference bargaining leverage obliquely in one example, the Agencies did not use this opportunity to elaborate how the theory works and what facts would be needed to establish a bargaining power case such as AT&T/Time Warner.

The draft Guidelines further do not contain much discussion of the types of facts that make the theories they lay out more or less likely to be a problem in a particular case. For example, in many instances upstream market shares are not as relevant to whether a merged firm could profitably raise prices or withhold inputs than is the ease with which a rival could substitute to a different provider of inputs: Withholding an input with a relatively low share can cause rivals to lose sales if consumers have strong brand loyalty or a taste for variety, or if important downstream rivals are locked-in to a particular technology. One recent example of this theory in action is AT&T/Time Warner, where DOJ argued that certain Time Warner content like HBO or CNN was "must-have" and thus contributed to increased bargaining leverage, regardless of what share these networks might have as a portion of total viewing hours.

By contrast, withholding an input with a very large share may not be problematic if the input is interchangeable across suppliers, other input suppliers can easily expand capacity, and there are not

[2] Complaint, *United States v. AT&T, Inc.*, No. 1:17-cv-02511 (Nov. 20, 2017), https://www.justice.gov/opa/press-release/file/1012896/download.

substantial cost differences between input providers. A recent example is the Essilor/Luxottica merger.[3] In that case, which combined ophthalmic lens manufacturer Essilor with optical frame manufacturer and optical distributor Luxottica, the FTC's closing statement explained that the transaction posed little risk of competitive harm, notwithstanding Essilor's high share in lenses, because it is easy for independent opticians to switch lens providers.[4]

Other similarly undiscussed topics include the role that minimum efficient scale plays in whether or not denying rivals access to customers will be successful, how a merger can remove a potential sponsor of new entry, or how a merger with one of few unintegrated input suppliers can increase barriers to entry by forcing an entering rival to enter at two levels of the supply chain at once.

It is also notable that despite the active vigorous worldwide debate around digital platforms and data, this topic is not addressed directly in the draft Guidelines.

Additional potential efficiencies in vertical mergers are also left unmentioned, such as that access to a guaranteed supplier or a guaranteed customer can facilitate investments where payback is long and conditions are uncertain.

Because the draft Guidelines have been released for comment, the public now has the opportunity to shape the final form that new Vertical Merger Guidelines will take. The comment period closes on February 11, 2020.

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[3] Cleary Gottlieb acted as antitrust counsel to the purchaser, Essilor, in the successful clearance of that vertical merger.

[4] Fed. Trade Comm'n, Statement of Federal Trade Commission Concerning the Proposed Acquisition of Luxottica Group by Essilor (Mar. 1, 2018), https://www.ftc.gov/system/files/documents/closing_letters/nid/1710060commissionstatement.pdf.