Assessment of the Vertical Merger Guidelines and Recommendations for the VMGs Commentary

Koren W. Wong-Ervin & John D. Harkrider*

On June 30, 2020, the DOJ and FTC released their Vertical Merger Guidelines (VMGs). We expect a VMGs Commentary to follow in the next few weeks or so. Overall, the Guidelines recognize that "vertical mergers often benefit consumers" (§ 1, at 2) and set forth non-exhaustive ways in which non-horizontal mergers may substantially lessen competition. The three primary theories described are foreclosure and raising rivals' costs, access to competitively sensitive information, and facilitating collusion. The Guidelines also cover harms from mergers that increase the cost of entry into a relevant market; mergers that disadvantage rivals through the acquisition of a complementary product; and "diagonal" mergers (i.e., those that combine firms or assets at different stages of competing supply chains).

This article provides an assessment of the key changes from the January 2020 Draft Guidelines. It also offers recommendations for the VMGs Commentary—namely, additional details on how the Agencies will determine the "net effect" when elimination of double marginalization (EDM) causes the merged firm to lower price, and raising rivals' costs (RRC) causes non-merging rivals to raise price (e.g., will the Agencies determine an industry-wide average retail price?). We also recommend guidance on remedies. These are important because one of the most important roles of guidelines is to provide private parties with the ability to evaluate and price risk ex ante.

Assessment of Key Changes from the Draft VMGs

Elimination of Quasi-Safe Harbor

The VMGs eliminate the suggestion from the Draft Guidelines that vertical mergers are unlikely to be anticompetitive when the merging parties' share of both a relevant market and related product are less than 20%. This change may be inconsequential given how little certainty the prior language provided and statements by DOJ and FTC officials that the 20% was not a safe harbor. The change may also be a positive development for deals over 20% in that it eliminates the risk that the 20% figure would be interpreted as a trigger for competitive concern (which was an issue with the language in the Draft Guidelines).

That said, the missed opportunity to include a true safe harbor (e.g., using the "will not challenge, absent extraordinary circumstances" language found in other DOJ-FTC guidance documents) seems contrary to prior Agency practice. A review of the Agencies' vertical merger settlements from 2000 through February 2020 reveals that, while there are a number of matters in which the Agencies did not allege market shares, there does not appear to be even a single instance in which the DOJ or FTC challenged a vertical merger that featured relevant market shares below 40%. In most cases in which the DOJ or FTC reported shares, those shares exceeded 70%. The absence of a safe harbor is also inconsistent with U.S. exclusive-dealing law (generally lawful if foreclosure less than 30-40%) and international norms (e.g., the European Union, Brazil, and France have screens for vertical mergers at 30% and Japan at 35%).

Treatment of Elimination of Double Marginalization

The big picture change is the move of the discussion of EDM (i.e., the elimination of double-markups in price by separate firms each with market power at different levels in a supply chain) from its own separate section to both the Unilateral Effects Section and a newly-titled "Procompetitive Effects" Section that replaces the prior Efficiencies Section.

Moving EDM to the Unilateral Effects Section and renaming the prior Efficiencies Section is positive: it at least implies that the Agencies recognize that EDM is not an efficiency because it can prevent RRC, not just net it out. In other words, because EDM and RRC arise from fundamentally the same economic changes in incentives—firm-wide profit maximization—the effects on downstream prices cannot be predicted without also calculating the benefits from EDM. As Dennis Calrton et al. (2019) have explained, "most vertical models," including the DOJ's in *AT&T/Time Warner*, automatically generate the efficiency effect of EDM when analyzing anticompetitive effects, i.e., EDM is inherent to the model. Along these lines, the Guidelines also add new language stating that EDM "is not a production, research and development, or procurement efficiency; it arises directly from the alignment of economic incentives between the merging firms. . . . the same source drives any incentive to foreclose or raise rivals' costs." (§ 6, at 11)

Relatedly, the VMGs helpfully replace the prior language that "the Agencies generally rely on the parties to … demonstrate" EDM with the statement that "it is incumbent upon the merging firms to provide substantiation for claims" of EDM. (§ 6, at 12) While "demonstrate" implies burden of proof, "substantiate" implies burden of production. This appears to be the clear intent of the change for at least Commissioner Christine Wilson, who stated in a 2020 Speech: "Under a symmetric approach to RRC and EDM, requiring parties to 'demonstrate' a merger's EDM would amount to demanding a full competitive effects analysis from merging parties–not, I think, the appropriate way to proceed. My view is that for any effects analysis, merging parties have a burden of production, but the Agencies bear the burden of proof."

One significant negative is the added explicit requirement that EDM be merger specific. (§ 6, at 12) While EDM can sometimes be eliminated with non-linear prices or quantity-forcing contracts, such contracts do not easily generate the same outcome as what a vertical merger could, given demand uncertainty, risk aversion, information asymmetries, and all sorts of incentive problems. The Guidelines state that, when assessing merger specificity, the Agencies consider "evidence, such as contracts between similarly situated firms in the same industry and contracting efforts considered by the merging firms." (*Id.*) The problem with this is 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.

The VMGs do at least say the "Agencies will generally take the same approach to evaluate the likely contractual arrangements absent the transaction as the one they use when evaluating raising rivals' costs or foreclosure." (*Id.*) They also say: "Creditable quantifications of the elimination of double marginalization are generally of similar precision and reliability to the Agencies' quantifications of likely foreclosure, raising rivals' costs, or other competitive effects." (*Id.*) These additions address the asymmetry problem--a concern expressed by critics that the Agencies tend to embrace probabilistic prediction, estimation, presumption, and simulation of anticompetitive effects on the one hand, while requiring efficiencies (or here, EDM) to be proven on the other.

Expansion to Non-Horizontal Transactions Beyond Vertical Mergers

The Guidelines add two non-vertical examples, one on "mergers of complements" (§ 4, Ex. 6, at 9) and the other on "diagonal" mergers (§ 4, Ex. 7, at 9-10), yet do not close the door to broader "conglomerate" theories.

There are two main problems with Example 6 on mergers of complements. The first is that the anticompetitive harm seems to be the ability and incentive to engage in discount-tying arrangements. The Example involves motors and batteries that are complementary inputs into the production of electric scooters. The Example states that the Agencies "may investigate whether the merged firm would have the ability and incentive to disadvantage rival manufacturers," including "by increasing the price of its motors (the related product) to its customers (e.g., electric scooter manufacturers) that do not also buy the merged firm's batteries." If the threatened motors price increase were high enough, such conduct could amount to a *de facto* tie or forced bundle. Not only is such conduct generally lawful, but it is more appropriately suited for post-merger conduct investigations.

As the DOJ explained in its 2001 OECD Note, one of the "problem[s]" with the theory that a merger may harm competition by facilitating the bundling of complementary products "is that it has been used in some cases to block mergers . . . on the basis of a theory of competitive harm that depends on a highly attenuated chain of causation that invites competition authorities to speculate about what the future is likely to bring." The DOJ concluded by saying: "Such hypothetical possibilities would not support a challenge under Clayton Section 7."

The second problem with Example 6 is the use of the term "disadvantage rivals" to describe the potential harm (a phrase that is also used in Example 5 on raising rivals' costs of distribution). It has long been clear under U.S. antitrust law that effects on rivals are not sufficient; in fact, such effects are often consistent with efficient mergers that promote vigorous competition.

Recognition That Vertical Mergers "Often Benefit Consumers"

The Guidelines add language stating: "vertical mergers often benefit consumers through the elimination of double marginalization, which tends to lessen the risks of competitive harm. While the agencies more often encounter problematic horizontal mergers than problematic vertical mergers, vertical mergers are not invariably innocuous." (§ 1, at 2) This statement does not go as far as prior U.S. statements, including the 2007 U.S. OECD Note, which states that "the overwhelming majority of vertical mergers increase efficiency" and "vertical mergers merit a stronger presumption of being efficient than do horizontal mergers." Still the new language represents an important recognition, particularly in light of empirical evidence indicating that vertical mergers are generally procompetitive or benign.

Recommendations Going Forward

First, while the VMGs describe theories of harm the Agencies may pursue, they offer few details on how the Agencies will weigh the upward price pressure created by RRC against the downward price pressure created by EDM to determine a "net effect." The Guidelines also repeatedly use the word "may" to describe what factors the Agencies are likely to consider and whether the existence of certain factors are likely to raise concerns (the use of "may" in this context occurs approximately 50 times throughout the VMGs). Greater clarity on these issues would provide parties with the predictability needed to evaluate risk.

Second, the VMGs do not address remedies. Such guidance is particularly needed in light of recent Agency statements, most notably by DOJ AAG Makan Delrahim, announcing the "return to the preferred focus on structural [over behavioral] relief." One area lacking clear guidance is how the Agencies classify remedies. For example, does a third-party arbitration dispute mechanism (which AT&T offered, and the DOJ rejected, in *AT&T/Time Warner*) amount to a costly regulatory scheme that requires monitoring and ongoing enforcement? Sound guidance on this issue is important given that limiting the availability of behavioral remedies risks sacrificing the significant efficiencies generally created by vertical mergers. For example, Example 6 on mergers of complements and discount-tying arrangements is all the more troubling if the Agencies continue to cast doubt on conduct remedies.

Third, for the reasons set forth above, we recommend that the VMGs Commentary clarify that "disadvantaging rivals" is not a sufficient basis for challenging a merger. Central to the raising rivals' cost theory is the fact that while conduct that raises rivals' costs may harm competitors, it does not harm competition unless the firm whose conduct is scrutinized is thereby enabled to raise its price above the competitive level.

Fourth, the VMGs leave open the possibility that the Agencies may pursue broader "conglomerate" theories. We recommend that the VMGs Commentary include an explicit statement that the Agencies will not pursue such theories. Such a statement would be consistent with the DOJ's 2001 OECD Note, which explains that "there is no empirical support for the notion that size alone conveys any significant competitive advantage that is not efficiency-related." A definitive statement on this is important, particularly given the Agencies' 2020 OECD Note stating that "[c]onglomerate mergers that raise neither vertical nor horizontal concerns are ***unlikely*** to be problematic under U.S. merger law."

Additional guidance is of critical importance. Uncertainty in enforcement can serve as a tax on transactions: the seller is concerned about risk of substantive concerns over foreclosure and risk that the deal may be blocked given that supply remedies are disfavored. These risks cause sellers to demand higher prices (or larger reverse break fees) to protect themselves, which effectively imposes a tax on the very deals that are likely to have procompetitive effects.

Endnotes

* Koren W. Wong-Ervin and John. D. Harkrider are Partners at Axinn, Veltrop & Harkrider LLP. The authors thank Jimmy Moore and Mark Whitener for their insightful comments. The views expressed here are the authors' alone and do not necessarily represent the views of Axinn or any of its clients.