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DOJ and FTC Jointly Announce Vertical Merger Guidelines

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On June 30, the U.S. Department of Justice and Federal Trade Commission jointly released revised Vertical Merger Guidelines (the "Guidelines"), which the agencies had not updated since 1984. The Guidelines describe how the agencies analyze a range of transactions that may raise vertical concerns, including vertical mergers (i.e., transactions involving firms or assets at different stages of the same supply chain), diagonal mergers (i.e., "those that combine firms or assets at different stages of competing supply chains"), and mergers involving complements (i.e., products or services that are sold separately but typically or necessarily used together).

According to the agencies, the Guidelines are intended to reflect their current enforcement policies. Therefore, we do not anticipate that the revision will result in a significant increase in vertical merger enforcement. But the issues the Guidelines address have engendered considerable debate, and we anticipate that the debate will continue as the agencies apply the Guidelines in practice.

Protecting Competition, Not Competitors

The Guidelines reiterate the well-established antitrust policy of protecting competition, not competitors. When the agencies evaluate a merger, they "examine effects on the actual and potential direct customers of the merging parties, and, if different, the final consumers of firms that utilize the goods or services of the merging parties." If a merger involves multiple levels of a supply chain, the agencies state that they consider actual and potential buyers of the downstream products, and presume that adverse effects on direct customers within a supply chain will lead to adverse effects on final consumers. Furthermore, these considerations are not limited to mergers that confer market power on sellers. The agencies also consider whether a merger enables the merged firm to acquire monopsony power—market power exercised as a buyer.

Market Definition

The Guidelines explain that early in the review of a vertical merger, the agencies will identify a relevant market and a related product. A relevant market is any antitrust market in which either the upstream or downstream party to the merger competes. For example, in a merger between a retailer and a manufacturer, the agencies would treat both the retail market and the manufacturing market in which each of the two merger parties compete as relevant markets.

A related product is “a product or service that is supplied or controlled by the merged firm and is positioned vertically or complementary to the products and services in the relevant market.” The related product can be upstream or downstream from the relevant market. The Guidelines provide an example of a retail chain that buys the manufacturer of a product: “the merged firm’s supply of Brand A cleaning products (the related product) could affect downstream competition between retailers in a given geographic area (the relevant market)” or “the merged firm’s retailing of cleaning products in a given geographic area (the related product) could affect competition between manufacturers of cleaning products in that area (the relevant market).”

Assessing Competitive Effects

The Guidelines point out that in assessing the competitive effects of a merger, the agencies consider market shares, concentration, and other available and reliable evidence following the methodology laid out in the 2010 Horizontal Merger Guidelines. Indeed, the Guidelines caution that because vertical mergers often involve horizontal components, the Vertical Merger Guidelines should be read in conjunction with the Horizontal Merger Guidelines. However, unlike the Horizontal Guidelines, the Vertical Guidelines provide no concentration thresholds “as screens for or indicator of competitive effects from vertical theories of harm.” This is a notable departure from the draft revision of the Guidelines the agencies published last January, which stated that the agencies were unlikely to challenge transactions resulting in a merged firm with less than a 20% share of the relevant market and less than a 20% share of the related product market. The DOJ appears to have abandoned that proposed threshold in response to a large number of public comments objecting to the threshold, some suggesting that it was too low and others that it was too high.

The Guidelines discuss two types of competitive harm that can arise from vertical mergers: unilateral effects and coordinated effects.

Unilateral Effects

The Guidelines focus on two types of unilateral effects: foreclosure and raising rivals’ costs, and access to competitively sensitive information. The Guidelines note, however, that these two types of unilateral effects do not comprise an exhaustive list.

Foreclosure and Raising Rivals’ Costs

Foreclosure and raising rivals’ costs may occur when a vertically integrated firm either refuses to supply rivals with a related product or continues to supply it to rivals but at a higher price or a lower quality. In determining whether a vertical merger raises the risks of foreclosure or raising rivals’ costs, the agencies evaluate the ability and incentive of the merged firm to do so. The ability element is satisfied if a firm can cause its competitors to lose significant sales in the relevant market or otherwise compete less aggressively. It is not satisfied, however, if rivals “could readily switch purchases to alternatives to the related product, including self-supply, without any meaningful effect on the price, quality or availability of products or services in the relevant market.” The incentive element is satisfied where a merged firm would find it profitable to foreclose rivals or raise their costs, usually through price increases which yield gains in the relevant market that outweigh losses from reduced sales of the related product. However, the Guidelines note that the evaluation of the effects of a merger is holistic. “This evaluation will generally include an assessment of the likely net effect on competition in the relevant market of all changes to the merged firm’s unilateral incentives. The merged firm may foreclose its rivals or raise their costs… but a vertical merger can also change other incentives. The elimination of double marginalization, for example, can confer on the merged firm an incentive to set lower downstream prices." (More on double-marginalization below.)

Access to Competitively Sensitive Information

The Guidelines also recognize that vertical transactions can give the merged firm access to and control of a rival's competitively sensitive information, another basis for a unilateral theory of harm. The Guidelines focus on examples of how such access can lead to competitive harm. For example, if a downstream rival was a customer of the upstream firm pre-merger, the merged firm may have access to sensitive information that would allow it to "moderate its competitive response to its rival's competitive actions," or to preempt or react quickly to its rival's procompetitive moves. This can deter rivals from taking procompetitive actions or force them to rely on less preferred trading partners rather than risk exposing their information to the merged firm.

Coordinated Effects

The Guidelines also describe the potential that vertical mergers may have to enable coordination among competitors. For example, if a firm in a downstream market merges with an upstream supplier of a related product on which competitors in the downstream market rely, the merged firm can use the threat of withholding the related product to ensure adherence to a tacit agreement with its downstream competitors to limit output or otherwise harm competition. Similarly, if a vertical merger gives the merged firm access to competitively sensitive information, that information can be used to facilitate an anticompetitive agreement by making it easier to detect cheating. However, the Guidelines also note that certain mergers can reduce the risk of coordinated effects if the elimination of double marginalization increases a merged firm's incentive to cheat on a tacit agreement.

Procompetitive Effects

The Guidelines note that the agencies will not challenge a merger if it creates merger-specific cognizable efficiencies "of a character and magnitude such that the merger is unlikely to be anticompetitive in any relevant market." The main procompetitive effect contemplated by the Guidelines is the elimination of double marginalization, which may occur if an independent upstream firm is able to price in a markup over its marginal cost, but a merged firm self-supplies the upstream product at cost and passes some of the savings on to the ultimate consumer. In determining whether the elimination of double marginalization is merger-specific, the agencies "typically examine whether it would likely be less costly for the merged firm to self-supply inputs following the merger than for the downstream firm to purchase them from one or more independent firms absent the merger." Generally, this is accomplished by examining evidence of existing contracting practices.

The Guidelines also note that mergers between firms that make complementary products can lead to more efficient pricing. "Absent the merger, the merging parties would set the price for each complement without regard to the impact of lower prices for one on demand for the other. If the two merge, the merged firm has an incentive to set prices that maximize the profits of the firm as a whole, which may result in lower prices for each component." The Guidelines also recognize that vertical mergers can create other efficiencies when a single firm controls assets at different levels of a supply chain, for example, by allowing it to "streamline production, inventory management, or distribution," or "create innovative products in ways that would not likely be achieved through arm's-length contracts." The agencies will also take these efficiencies into account when evaluating the overall effects of the merger.

Dissenters' Concerns

The Guidelines were adopted by the FTC by a vote of 3-2, with Commissioners Rohit Chopra and Rebecca Kelly Slaughter issuing dissenting statements. Commissioner Chopra questioned the Guidelines' silence on the ways in which vertical mergers can erect barriers to entry, including diminished access to capital, control of a market by a participant, the winner-take-all nature of digital markets due to network effects [1], the self-reinforcing advantages of data, or increased customer acquisition costs. Commissioner Slaughter argued that the Guidelines overstate the value of the elimination of double marginalization. In her view, the Guidelines presume that vertical mergers will result in eliminating double marginalization as a matter of course, while failing to recognize that existing contracts, switching costs, and other practical considerations may prevent the elimination of double marginalization.

[1] A network effect occurs when the value of a good or service increases as more consumers use it. For example, telephone systems exhibit network effects. Before telephones were widely adopted, communicating with them was not very useful because a user could not reach many other people by phone. But as more people installed telephones, the telephone became an increasingly valuable means of communications because a user could reach larger numbers of people. Many networks that connect large groups of users exhibit network effects, including the internet, many online services, and payment systems, to name just a few.

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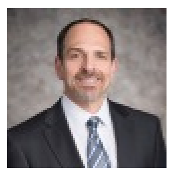

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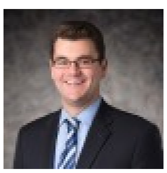

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