DOJ and FTC Release Draft Vertical Merger Guidelines for Public Comment

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January 21, 2020 — On January 10, the DOJ Antitrust Division and FTC jointly released draft Vertical Merger Guidelines for public comment. The purpose of the Guidelines is to "outline the principal analytical techniques, practices and enforcement policy" of the U.S. federal antitrust agencies with respect to vertical mergers, i.e., transactions that combine firms or assets that operate at different stages of the same supply chain. The proposed draft represents the agencies' first revision to Guidelines since 1984, in stark contrast to the agencies' Horizontal Merger Guidelines, which they have updated periodically over the years, most recently in 2010.

These new proposed Vertical Merger Guidelines, as written, could signal increased scrutiny of proposed vertical mergers at much lower levels of market concentration than has been the case for the last several decades. The agencies state, however, that the proposed Guidelines are simply intended to reflect current enforcement policy. Therefore, we do not anticipate that they will result in a significant increase in vertical merger enforcement. But the proposed Guidelines are likely to generate considerable debate before they are finalized.

Identifying the affected markets

In analyzing vertical mergers, the proposed Guidelines state that the agencies will begin their analysis by identifying a relevant market in which one of the two merging firms compete and in which the merger might substantially lessen competition. The agencies will then identify any "related product" supplied by the other merging firm. The proposed Guidelines define a "related product" as one that "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." They cite as examples inputs, means of distribution, and access to customers. In defining the scope of the relevant market and the markets for any related products or services, the agencies will use the same methodology for defining markets described in the Horizontal Merger Guidelines.

Potential safe harbor

The proposed Guidelines state that the agencies are "unlikely" to challenge a vertical merger where the merged firm has "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." While the proposed Guidelines do not explicitly describe this provision as a safe harbor, and in fact caution that mergers with shares below the threshold may still raise competitive concerns in certain circumstances, the threshold may prove to function as a safe harbor for any merger below the threshold. In contrast with the Horizontal Merger Guidelines, however, the proposed Vertical Merger Guidelines do not provide any guidance regarding a threshold above which market share or concentration becomes presumptively anticompetitive.

Theories of anticompetitive harm

The proposed Vertical Merger Guidelines state that a vertical merger may lessen competition either through unilateral effects or coordinated effects.

Unilateral effects. The proposed Guidelines highlight two theories of unilateral anticompetitive harm that may arise from a vertical merger: (i) foreclosure and raising rivals' costs, and (ii) access to competitively sensitive information. With respect to the first theory, the chief concern is that a vertical merger may make it profitable for the merged firm to charge its rivals higher prices for the related product, lower product quality, or refuse to supply rivals altogether, thereby weakening or removing competition in the relevant market. These strategies may be profitable for the merged firm if it is able to capture enough of the sales that its stratagem causes its rivals to lose. The agencies note that they may use merger simulations to quantify the likely unilateral price effects resulting from a merger. The proposed Guidelines, however, do not provide any guidance as to how great the magnitude of likely foreclosure or raising rivals' costs must be in order to give rise to antitrust concerns, other than to state that the magnitude must be more than "de minimis" in order to substantially lessen competition.

The paradigmatic example of the second type of unilateral competitive harm, access to competitively sensitive information, is when a merged firm "gain[s] access to and control of sensitive business information about its upstream or downstream rivals that was unavailable before the merger." This can become an issue where a downstream rival of the merged firm was a premerger customer of the upstream firm, potentially forcing the rival to seek upstream components from a less competitive source in order to protect its confidential information.

Coordinated effects. The proposed Guidelines also identify ways in which a vertical merger may enable or increase anticompetitive coordinated effects. One is "by eliminating or hobbling a maverick firm that otherwise plays or would play an important role in preventing or limiting anticompetitive coordination in the relevant market." Another is through "changes in market structure or the merged firm's access to confidential information," which may "facilitate (a) reaching a tacit agreement among market participants, (b) detecting cheating on such an agreement, or (c) punishing cheating firms." The proposed Guidelines recognize, however, that in certain market situations, a vertical merger may reduce the risk for coordinated action, for example, when cost savings achieved through the elimination of double marginalization[1] may give a merged firm an incentive to cheat on a collusive agreement.

Efficiencies

Finally, the proposed Guidelines detail potential efficiencies the agencies will consider when evaluating vertical mergers. In particular, the proposed Guidelines identify the elimination of double marginalization as a potential efficiency that may result when the merging firms have market power in both the upstream and downstream markets. Other potential efficiencies the proposed Guidelines identify include the reduction of "contracting frictions," and improved coordination that results in more streamlined production, inventory management, distribution, or innovation. The proposed Guidelines, however, would place the burden of demonstrating these efficiencies on the parties to the proposed merger, rather than presuming them as the agencies and courts have done in the past.

Potential remedies

The proposed Guidelines are silent as to potential remedies for vertical mergers that may substantially lessen competition. In the past, the agencies have relied more heavily on behavioral remedies with respect to vertical mergers—such as a consent decree requiring the merged company to continue supplying a rival—than horizontal mergers. More recently, the agencies have signaled that they will be less likely to accept behavior remedies than in the past, which would mean more reliance on partial divestitures as a condition to approving a transaction.

Comment period

While the proposed Guidelines offer significant guidance, they also raise numerous questions. These will undoubtedly be the focus of many of the public comments the agencies receive. The deadline for public comments is February 11. Issues we expect these comments to address include the following.

1. Should the Guidelines provide more guidance as to the circumstances in which a merger is likely to raise rivals' costs sufficiently to result in a substantial lessening of competition? In the past, the courts and agencies have challenged vertical mergers on these theories only in very highly concentrated markets. Do the proposed Guidelines signal a departure from that enforcement policy?
2. As in the past, should there be a presumption that vertical mergers will generate merger-specific efficiencies through the elimination of double marginalization, through a reduction in transactions cost (or contracting frictions as the proposed Guidelines call them), and through more efficient coordination in the production and distribution of vertically related goods and services?
3. Will the agencies continue to accept behavioral remedies with respect to vertical mergers that might otherwise substantially lessen competition, as it has in the past?
4. What efforts do the agencies plan to make to explain the economic models they use in their merger simulations and the data quality standards they apply?

If you have questions about the likely impact of the proposed Vertical Merger Guidelines, or would like to consider filing comments on them, please contact us.

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[1] Double marginalization occurs when two firms at different levels of a supply chain each have a degree of market power in their respective markets, which enables each one to extract a supra-competitive margin at its stage of production. The price paid by the ultimate consumer reflects both margins.

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