Comments on Proposed Vertical Merger Guidelines

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General Comments:

The proposed Vertical Merger Guidelines provide little practical guidance, especially on the key issue of what would lead one of the Agencies to determine that it will not challenge a vertical merger. Although they list the theories on which the Agencies focus and factors the Agencies "may consider," the proposed Guidelines do not set out conditions necessary or sufficient for the Agencies to conclude that a merger likely would substantially lessen competition. Nor do the Guidelines communicate generally how the Agencies analyze the nature of a competitive process and how it is apt to change with a proposed merger.

The proposed Guidelines communicate the Agencies' enforcement policy in part through silences. For example, the Guidelines do not mention several theories that have appeared in recent commentary and thereby signal that Agencies have decided not to base their analysis on those theories. That silence is constructive, but the Agencies' silence on the nature of their concern with vertical mergers is not. Since 1982, the Agencies' merger guidelines have always stated that their concern was market power. Silence on this subject might suggest that the Agencies' enforcement against vertical mergers is directed to something else.

The Guidelines' most conspicuous silence concerns the Agencies' general attitude toward vertical mergers, and on how vertical and horizontal mergers differ. This silence is deafening: Horizontal mergers combine substitutes, which tends to reduce competition, while vertical mergers combine complements, which tends to enhance efficiency and thus also competition. Unlike horizontal mergers, vertical mergers produce anticompetitive effects only through indirect mechanisms with many moving parts, which makes the prediction of competitive effects from vertical mergers more complex and less certain.

The Guidelines also are unhelpfully silent on the basic economics of vertical integration, and hence of vertical mergers. In assessing a vertical merger, it is essential to appreciate that vertical mergers solve coordination problems that are solved less well, or not at all, by contracts. By solving different coordination problems, a vertical merger can generate merger-specific efficiencies or eliminate double marginalization. But solving a coordination problem need not be a good thing: Competition is the ultimate coordination problem, and a vertical merger can have anticompetitive consequences by helping to solve that coordination problem.

Finally, the Guidelines are unhelpfully silent on the fundamental policy issue presented by vertical merger enforcement: What distinguishes a vertical merger that harms competition from a vertical merger that merely harm competitors? A vertical merger cannot directly eliminate rivalry by increasing market concentration. The Supreme Court has endorsed a foreclosure theory under which the merger directly causes injury to a rival and thus proximately causes diminished rivalry. Vertical mergers also might diminish rivalry in other ways, but the proposed Guidelines do not state that the Agencies view diminished rivalry as the hallmark of a lessening of competition.

Section 1:

The definition of vertical mergers is important and should be in the text. The definition of vertical mergers now in note 1 is unclear: The Guidelines should explain or illustrate a vertical merger that combines "assets" rather than firms. The definition of vertical mergers in note 1 also is unduly literal. It excludes mergers combining complements at the same level of the supply chain, even though such mergers present the same economic issues as mergers combining complements at adjacent levels. The exclusion of mergers combining complements at the same level will be cited by people agitating for yet another set of merger guidelines.

The last clause of the first paragraph is not quite right. The "1950 amendments" must refer to the statute itself, and it said nothing about vertical mergers. Of course, the House report on the 1950 amendments did indicate that the amended Section 7 was meant to encompass vertical mergers, and the Supreme Court adopted that view in *Brown Shoe*.

Section 2:

The Guidelines say the Agencies will define a relevant market and a "related product," but section 2 is unclear as to the meaning of the "relevant product," which is the Guidelines' main innovation and should be carefully explained. Example 2 indicates that the "relevant product" is nothing like a market in that the supplier of the good or service is part of the definition of "relevant product" ("*The Agencies may identify Company B's supply of oranges as the related product.*"). Section 2 indicates that the "relevant product" can be a "means of distribution" or "access to a set of customers" and thus not a product at all.

The examples in sections 2 and 3 should be used to make the meaning of "related product" clear, and at present, Example 1 could do more harm than good. Saying that "the Agencies may identify two relevant markets" contradicts the text, which says that the Agencies will define a single relevant market. And saying that "the Agencies may identify two relevant markets" undermines the apparent purpose of the example, which is to explain that either the upstream or downstream market could be "the relevant market."

Section 3:

Language matters a great deal on how safe the 20/20 threshold is perceived to be, and the Guidelines do not use language communicating that the harbor is safe. The basis for the Agencies' reticence is a puzzle. The Agencies have not in recent decades challenged vertical mergers under the 20/20 threshold, and it is unimaginable that a court today would find a vertical merger to be both unlawful and also under the 20/20 threshold.

The concluding paragraph of this section is somewhat confused and does not effectively make what seems to be its main point—that mergers outside the not-entirely-safe harbor are not necessarily suspect. Contrary to what the paragraph says, the purpose of the 20/20 thresholds really is "to separate competitively benign mergers from anticompetitive ones." The separation might be imperfect, but the thresholds are used for the single purpose of making that separation. The separation would be effective and potentially useful if, for example, no mergers on one side of the line posed significant competitive problems, and just a small minority of mergers on the other side of the line posed significant competitive problems.

The separation would be ineffective and useless if, for example, a small minority of mergers on both sides of the line posed significant competitive problems, but the first sentence of the concluding paragraph suggests that this is what the Agencies are saying. If that is what they are saying, the 20/20 threshold should be deleted.

If the Agencies are prepared to make the harbor safe, the concluding paragraph need only say that mergers exceeding the 20/20 threshold are not necessarily suspect or likely to be challenged. That point would be communicated more clearly without the last clause: "and some others for which it is particularly important to examine other competitive factors to arrive at a determination of likely competitive effects."

The "used in" phrasing of the second part of the 20/20 threshold works only in some of the scenarios covered by the Guidelines, and in those scenarios, "of the relevant market" could be understood in a manner that surely was not intended. To illustrate the latter point, suppose that: (1) the related product is mineral A from X; (2) 10% of the A used in the relevant market is from X; and (3) every firm in the relevant market gets some A from X. On these facts, it makes linguistic sense to say that A from X is "used in 100% of relevant market" because every part of the relevant market uses A from X. The intention, however, appears to have been to say, under the supposed facts, that A from X "is used in less than 20 percent of the relevant market." In addition, suppose that the relevant market is the sale of B in Y, and the related product is getting B to Y, say by a pipeline. The pipeline is not used "in" some percentage of "of the relevant market." A preferable formulation for the second part of the threshold might be that "the relevant product is used in, or by, less than 20 percent of the output of relevant market."

Section 4:

The sentence that potentially is the most helpful is: "The types of evidence described in Section 2.1 of the HMG can also be informative about the effects of vertical mergers, including: actual effects observed in consummated mergers, direct comparisons based on experience, and evidence about the disruptive role of a merging party." But all three suggested types of evidence present problems.

Evidence on the "actual effects observed in consummated mergers" was a large part of what sank the Justice Department's case against AT&T's acquisition of Time-Warner. Most of that evidence should have been deemed uninformative because past mergers examined by the defense expert would not have been predicted to have anticompetitive effects, but the court relied on it anyway. Releasing the proposed Guidelines in their present form would make it even more difficult for the Agencies to convince a court that such evidence is uninformative.

Under the heading "direct comparisons based on experience" section 2.1.2 of the 2010 Horizontal Merger Guidelines explains that "the Agencies look for historical events, or 'natural experiments,' that are informative regarding the competitive effects of the merger." But neither set of guidelines indicates what historical events, other than past vertical mergers, the Agencies might find informative on the likely effects of vertical mergers. And neither set of guidelines explains how the Agencies can glean much from observing historical events. Econometricians try to find appropriate "instruments" or "controls" that allow the statistical identification of counterfactual effects, but the word "direct" suggests that econometrics is not what the Agencies have in mind.

Under the heading "disruptive role of a merging party," Section 2.1.5 of the 2010 Horizontal Merger Guidelines describes evidence directly relevant to coordinated effects theories in the Horizontal Merger Guidelines. The proposed vertical Guidelines, however, articulate largely different coordinated effects theories, and when investigating a vertical merger, the Agencies presumably would look for evidence on the disruptive role of a non-merging rival in the relevant market, rather than the "disruptive role of a merging party." The proposed vertical Guidelines articulate the concern that "the merged firm could use its power over a product or service in a related product to harm the ability of a non-merging maverick in the relevant market to compete."

Section 5:

Subsection a. does not get across the point that a vertical merger can (1) make anticompetitive conduct possible, (2) create an incentive to engage in anticompetitive conduct, or (3) do both. In the list of things that the Agencies "may consider," one item goes to incentive, and a parallel item should be added that goes to possibility.

Section 6:

Section 6 do not explain how the Agencies go about assessing the extent of double marginalization before a merger or the impact of a vertical merger in eliminating double marginalization. As this is a major issue with vertical mergers, something more than vague possibilities would be highly desirable. Readers cannot find the needed guidance in case law or treatises.

This section suggests that the vertical coordination problem might have been solved, and double marginalization thereby eliminated, without a merger. But if so, most of the anticompetitive effects that could follow from a merger, especially raising rivals' costs, also might have been achieved without a merger.

The last sentence of section 6 ("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.") is unhelpful because the Guidelines do not address what makes a merger anticompetitive.

Section 8:

This section would be more useful if it explained how vertical coordination can generate efficiency, and if it explained general principles about how vertical integration can be more effective than contracts in accomplishing efficient cooperation.