Comments to the Antitrust Division of the U.S. Department of Justice and the Federal Trade Commission

Concerning

U.S. DEPARTMENT OF JUSTICE AND THE FEDERAL TRADE COMMISSION
DRAFT VERTICAL MERGER GUIDELINES
RELEASED FOR PUBLIC C

Executive Summary

These comments are submitted by Dr. Fowdur and Dr. Morris, who collectively have worked on or submitted testimony in dozens of vertical transactions in the electric energy, natural gas, petroleum, video content, pharmaceutical, and healthcare industries. This background provides a unique perspective on the Draft Vertical Merger Guidelines.

We summarize our specific recommendations as follows:

- Use terminology familiar to the business community and antitrust practitioners, such as "upstream" and "downstream" stages of production instead of "relevant" and "related" stages.
- Explicitly state that high market concentration is necessary at both the upstream and downstream levels for likely anticompetitive effects.
- Explicitly state whether 20% market shares are necessary at both the upstream and downstream levels for likely anticompetitive effects.
- Consider including alternative downstream shares and market concentration measures.
- Make Market Power Pressure Indices more explicit.
- Revise or drop Example 5.
- Revive potential competition considerations.
- Restore the regulatory evasion theory.

transactions. Section IV provides eight specific recommendations to improve the guidance and clarity in the Vertical Merger Guidelines.[1]

We recommend that the Agencies: (1) use terminology familiar to the business community and antitrust practitioners; (2) acknowledge that both the upstream and downstream markets need to be concentrated for likely anticompetitive effects; (3) clarify the 20 percent threshold; (4) consider alternative downstream shares and market
W L O W H \

WE " V \
W K \

and require careful analysis. If the Draft Vertical Merger Guidelines cannot simply and clearly distinguish between transactions that are within each of these three categories, then we question their value.

The Draft Vertical Merger Guidelines reflect an apparent concern that some anticompetitive mergers might be classified within the safe harbors designed for transactions that are unlikely to be anticompetitive. Properly crafted safe harbors, however, can adequately mitigate such concerns. For example, even economists who have called for greater vertical merger enforcement accept that anticompetitive effects are unlikely when both the upstream and downstream markets are unconcentrated.[2] A statement that both markets must be concentrated does not unduly constrain the Agencies. Rather, it simply acknowledges what threshold conditions the Agencies would need to demonstrate anticompetitive effects in the course of a merger investigation, or ultimately, in the context of litigation.

The Agencies might also be concerned that requiring both the downstream (relevant) market and the upstream (related) market to be highly concentrated doubles their burden because they have to define two markets instead of one. Once again, this is an unwarranted concern because the burden of persuasion already rests with the Agencies to show that downstream firms could not find alternative substitutes to the potentially foreclosed supplies of the upstream merging party.[3] And, similarly, the Agencies need to demonstrate that customers of the downstream merging party could not find good substitutes. Finding

---

[2] *See, for example*, Jonathan Baker, Nancy Rose, Steven Salop, & Fiona Scott Morton, *Five Principles for Vertical Merger Policy*, 33 ANTITRUST 12, 16 (2019) ("Vertical mergers involving firms in at least one oligopoly market raise the greatest competitive concerns. If both markets are unconcentrated, it is less likely that a vertical merger would be anticompetitive.") As discussed in section IV.B, we believe that anticompetitive effects are unlikely unless both the upstream and downstream markets are concentrated. The level of concentration at which substantial anticompetitive effects become more likely is not as clear. We favor a requirement for upstream and downst e # e # ` e
H D U H%

the set of potential alternative products and suppliers closely hews to the delineation of the upstream and downstream markets. Therefore, clearly stating the requirement in the Vertical Merger Guidelines does not increase the Agencies' burden.

The Vertical Merger Guidelines, like any enforcement guidelines, seek to balance an increase in the probability of preventing or dissuading anticompetitive transactions with a decrease in the probability of inadvertently stopping transactions that would benefit consumers. Vague guidelines do the opposite by decreasing the probability of preventing anticompetitive mergers and increasing the probability of stopping beneficial mergers.

Vague guidelines decrease the probability of preventing anticompetitive mergers for at least two reasons. First, without clear guidance, businesses are more likely to propose anticompetitive transactions in the hope that they are not stopped. But more importantly, vague guidelines increase the burden on Agencies. Due to vague guidelines, Agencies can waste resources investigating transactions that would otherwise not be filed. Similarly, vague guidelines fail to provide courts with information as to transactions that are likely to be anticompetitive. Without such guidance, courts are less likely to rule against anticompetitive transactions.

Vague guidelines can also deter procompetitive mergers. Because of vague guidelines, some business will not attempt procompetitive transactions that clear and correct guidance would foster. In such cases, consumers would lose the benefits of procompetitive transactions. In addition, vague guidelines increase the likelihood that procompetitive transactions will receive intense scrutiny, which again wastes Agency resources, and also acts as a tax on procompetitive mergers,

advise that the transaction would be unlikely to generate anticompetitive effects. A low market share would be 30 percent or below, and low market concentration would be 2,500 or below.[5] In these cases, the upstream merging party would be unlikely to possess an ability to raise upstream prices appreciably or to restrict supplies to rival downstream companies; therefore, anticompetitive effects would be unlikely.

Second, we examine the share of the upstream product that is used as an input into the downstream market. When one of the merging parties has an upstream market share higher than 30 percent and the upstream market concentration is higher than 2,500, we investigate the disposition of the upstream product. We would conclude that anticompetitive effects would be unlikely if less than 30 percent of the upstream product is used in as an input into the downstream market. As an example, electricity is generated from solar energy, wind energy, water, nuclear fuel, coal, natural gas, and various oil products. If the upstream product is distillate fuel oil (DFO), only a small fraction of DFO output is used for electric power generation.[6] Hence, vertical integration of a refiner and an electric generator would be unlikely to have anticompetitive effects because so little of the upstream product is used to generate electricity. Specifically, integration of a refiner and an electric generator would be unlikely to affect pricing decisions for DFO, even if DFO supplies were highly concentrated and the merging upstream refiner had a high share of DFO production in a region. On the other hand, 35 percent of natural gas consumed in the U.S. in 2018 was used for electric power

---

[5] This market share threshold would harmonize the U.S. Vertical Merger Guidelines with the EU Guidelines. *See* 2008 O.J. (C 265) 7, 9 ("The Commission is unlikely to find concern in non-horizontal mergers . . . where the market share post-merger of the new entity in each of the markets concerned is below 30% and the post-merger HHI is below 2,000." [Note omitted]). Notwithstanding the lower concentration threshold, we find anticompetitive effects unlikely when the upstream share is less than 30 percent and the upstream concentration is less than 2,500.

[6] According to data from the Energy Information Administration, less that 1 percent of DFO was used for electric power generation in 2017. *See* data at

generation.[7] Accordingly, combinations of natural gas suppliers with electric generators might raise concerns.

Third, we consider the share of output in the downstream market produced using the upstream input produced by a merging party, or the coverage ratio of the upstream input. For example, 35 percent of electric generation nationwide, with substantially higher shares in some areas, comes from natural gas.[8] Thus, a monopoly pipeline supplier of natural gas may have a substantial coverage ratio. Although the coverage ratio is important for our analyses, we would consider it in combination with a fourth share--the share of the merging parties in the downstream market. Typically, the downstream market is the primary market of concern because it is closest to consumers or end users. We find that the downstream market share provides valuable information when it is combined with the coverage ratio because the downstream share measures direct control, while the coverage ratio measures indirect control of the downstream market. When combining these numbers, it is necessary to remove any overlap to prevent double counting. To the extent that the coverage ratio includes a merging party's downstream sales that were produced from inputs of the upstream product from the other merging party, there would be double counting. Specifically, the combined input coverage/downstream share sums the downstream share and the coverage ratio but subtracts the merging party's downstream sales that were produced from inputs from the other merging party. When the input coverage combined with downstream

an intermediate case where the downstream market is not served by a monopolist and the downstream market is highly concentrated.

Only if a transaction fails all of these screens would we advise that a more complete analysis is necessary. Our preferred analysis would be of generalized Market Power Pressure Indices, which we discuss in more detail in Section IV.E., below. If these indices indicate likely anticompetitive effects, we would also make other qualitative inquiries that do not fall as neatly into an economic modeling framework, including analyses of entry conditions, product repositioning, and efficiencies other than the elimination of double marginalization (which is addressed with the Market Power Pressure Indices, below).

IV. Specific Recommendations to Improve the Vertical Merger Guidelines

A. Use Terminology Familiar to the Business Community and Antitrust Practitioners

We recommend that the Agencies refer to the interrelated levels of the vertical chain as "upstream" and "downstream" markets instead of "relevant" and "related" product.

Upstream and downstream levels of production are customary terms when discussing vertical relationships. As concisely explained in footnote 2 of the Draft Vertical Merger Guidelines, a vertical merger involves a combination of companies operating at two different levels of the same supply chain. The stage closer to final consumers is the downstream stage and the stage further from final consumers is the upstream stage. Every vertical merger involves a combination of upstream and downstream companies. Upstream and downstream reflect the customary way of categorizing the two companies in both economic and legal literature, and we recommend that the Agencies use these familiar terms in their new Vertical Merger Guidelines.

Despite the common usage of upstream

that when both upstream and downstream markets remain unconcentrated, both upstream and downstream buyers will have sufficient alternatives to the merged entity, and the merged entity will be unlikely to have an ability to exercise market power in either market. But even when only one of the two markets is unconcentrated, anticompetitive effects are unlikely. When the upstream market is unconcentrated, then the downstream firms would have good alternatives to the merged company for buying inputs. The upstream merging partner would not have power over price, which would make foreclosure effects unlikely. When the downstream market is not concentrated, anticompetitive vertical effects are unlikely because even if the upstream merging partner had an ability to raise downstream rivals' costs, the merged entity would be unlikely to recoup sufficient margins in the downstream market to make up for the lost volume in the upstream market. In other words, the upstream company would already be receiving most of the potential profits at the upstream level, giving little incentive to attempt foreclosure.[19]

We note that others have been willing to explicitly state that both the upstream and downstream markets must be highly concentrated for likely anticompetitive effects from vertical transactions. FERC, for example, has stated "highly concentrated upstream and downstream markets are necessary, but not sufficient, conditions for a vertical foreclosure strategy to be effective."[20] A similar statement would provide useful guidance to business, antitrust practitioners, and the courts. Accordingly, we recommend that the Agencies provide a clear statement that a specific concentration threshold is necessary at both the upstream and downstream vertical levels before anticompetitive effects from vertical transactions are possible.

¶ 31,111, 65 Fed. Reg. 70,983 (2000), at pp. 31,909-911. (". . . highly concentrated upstream and downstream markets are necessary, but not sufficient, conditions for a vertical foreclosure strategy to be effective.") [hereinafter "FERC Order No. 642"].

[19] We acknowledge that there is a literature on variable proportions at the downstream production stage that shows a theoretical possibility of anticompetitive effects from an upstream monopolist integrating downstream. *See, for example*, Warren-Boulton (1978), *supra* note 14. For the reasons discussed in section III, we do not view this possibility as a sound basis for merger enforcement policy.

[20] FERC Order No. 642, *supra* note 18, at p. 31,911.

C. Clarify the 20 Percent Threshold

We recommend that the Agencies clarify the 20 percent threshold.

The Draft Vertical Merger Guidelines at 3 state:

> The Agencies are unlikely to challenge a vertical merger where the parties to the merger have 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.

We find this statement ambiguous, and it raises several issues that we now address.

We interpret the statement to mean that the Agencies are unlikely to challenge a vertical merger where the merging parties jointly have a share of less than 20 percent in the downstream market and the upstream product produced by the merging parties is an input to less than 20 percent of the downstream output or capacity. For example, the Agencies would not challenge a merger of an electric generation company and a natural gas pipeline company if the generation company accounted for less than 20 percent of the downstream electric energy market and less than 20 percent of the electricity generated in the downstream market used inputs of natural gas from the merging pipeline. If that is the meaning, then it should be stated explicitly. If the Agencies meant something else, then it would be desirable to make the statement more explicit.

We seriously doubt that the two share thresholds as articulated provide valuable guidance for vertical cases. Four shares are important in determining whether a transaction is a candidate for additional investigation of likely competitive effects, as discussed in section III above. Beginning at the upstream level, it is necessary for the upstream company to have market power in its market so that it can affect upstream prices or supplies in a meaningful manner. As discussed in section III, we recommend that an upstream supplier to have at least a 30 percent share in the upstream market to warrant a closer examination of potential anticompetitive effects. We would also calculate the percentage

of the upstream product that is used in the relevant downstream market, and require a 30 percent share or higher. We would also calculate the share of the upstream product that is used for supplies in the downstream market, the coverage ratio, and the downstream market share of the merging parties.

As we discussed in Section III above, neither the downstream coverage nor the share of downstream sales by itself is relevant for a competitive analysis. Rather, it is the combination of the two shares for the merging parties that is relevant because the combined share quantifies the amount of the downstream output that is directly or indirectly controlled by the merged company. In the case of the acquisition of Enova Corporation

RU `€

The above analysis is incomplete and not sufficient by itself to establish that the Pacific Enterprises/Enova transaction was anticompetitive. Pacific Enterprises had a monopoly on natural gas supply to Southern California. If it had a monopoly, why were natural gas prices below the maximum level that Pacific Enterprises might obtain? In addition, did Pacific Enterprises have the ability to raise electric power prices?

Dr. Morris addressed these issues in his affidavit

results, many practitioners consider a GUMPPI of less than 5 percent to be a "safe harbor" and of 5 to 10 percent to be "likely competitively benign."[40]

One potential advantage of the GUMPPI is that it can simultaneously combine procompetitive and anticompetitive incentives into the same statistic. Consider a hypothetical merger of two companies, Upstream and Downstream, and the two strategies are to raise the Upstream and the Downstream prices. Begin with raising the Downstream price. The GUMPPI measures the additional Upstream profits divided by the product of the Downstream lost sales due to the price increases and the initial Downstream price. If Upstream only sells to Downstream, then the change in Upstream profits will be negative, indicating an incentive for the merged firm to have lower downstream prices compared to the pre-transaction level. Therefore, the merger will be competitively benign or procompetitive. On the other hand, if Upstream only sells to Downstream's rivals, then the Upstream profits will increase as Downstream sales shift to those companies that Upstream supplies. In this case, the GUMPPI indicates that the transaction increases the incentive to increase downstream prices; therefore, the merger might be anticompetitive depending on the value of lost downstream sales relative to gained upstream margins. The likelihood of anticompetitive effects is positively related to the GUMPPI.

The other test is to increase the Upstream pUpstr-

sells to Downstream's rivals, then the Downstream profits will increase and produce a positive GUMPPI, indicating that the merger would create an incentive to increase the Upstream price. In this case, the GUMPPI would indicate that the transaction might be anticompetitive, depending on the value of lost upstream sales relative to the gained downstream margins. The likelihood of anticompetitive effects once again is positively related to the GUMPPI. The GUMPPI automatically balances the intermediate cases in which Upstream sells to Downstream and its rivals, and the GUMPPI provides a measure of the likelihood of net anticompetitive effects. For example, if Upstream sells to Downstream and Downstream's rivals and the GUMPPI is negative, that would indicate that the transaction on net gives an incentive for lower prices and the transaction could be viewed as procompetitive on net.

F. Revise or Drop Example 5

We recommend that the Agencies revise or drop Example 5 because the hypothem g I. T M i A

be efficient and lead to an output expansion.[41] Therefore, the priors on the integration is that it is procompetitive. It is conceivable that after 10Mgr] R R Mthe 2

two companies exist at both the upstream and downstream level and the potential concern is integration forcing two-stage entry of a third firm.

Finally, we note that this example highlights the narrow window of likely anticompetitive effects from vertical mergers. When sustainable monopoly exists at one stage, it seems unlikely that a vertical transaction would be anticompetitive. At the opposite extreme, when either of the vertical stages are competitive, vertical transactions are also likely to be procompetitive. It is only when both stages are highly concentrated, but with two or more companies, that anticompetitive effects are likely to be a concern.

G. Revive Potential Competition

We recommend that the Agencies provide additional guidance on transactions that reduce potential competition.

The DOJ has rescinded the guidelines on potential competition theories, and the Draft Vertical Merger Guidelines do little to provide guidance on this issue. Although the existing Horizontal Merger Guidelines state that they address "the enforcement policy of the . . . Agencies . . . with respect to mergers and acquisitions involving actual or potential competitors . . ."[42] they provide little guidance on the issue. The only other comment on potential competitors is in section 5.1, which discuss chg mh] t tisiTamts. sttes that

theories in which a vertical merger might result in the foreclosure of supplies to a potential rival, but they do not address the direct acquisition of a potential rival.

We recommend that p ~ lm 6 # m r l

Appendix

Dr. John R. Morris is a Principal at Economists Incorporated, where he is an expert on competition and price formation in energy industries. He has provided competition studies and testimonies concerning many of the largest electric utility and natural gas mergers during the past 30 years. He ha