COMMENTS ON THE JANUARY 2020 DRAFT VERTICAL MERGER GUIDELINES

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1. Introduction

We offer these comments on the Draft Vertical Merger Guidelines released by the U.S. Department of Justice and the Federal Trade Commission ("the agencies") on January 10, 2020 (hereafter the "draft guidelines"). Our aim is to provide input that will help improve the final guidelines and further the goal of providing useable guidance to practitioners and to the business community. To that end, the draft guidelines and this comment process are a welcome improvement over the lingering fragments from section 4 of the 1984 Merger Guidelines that had remained the only published form of guidance from the agencies for over 35 years. Those fragments had no mention of vertical merger theories that have come to be at the forefront of modern enforcement, such as foreclosure and raising rivals' costs.

Our goal with these comments is not to advocate for any particular policy choice. Instead, we discuss several points of confusion about vertical mergers that the draft guidelines allow to persist. We believe that if implemented without changes, the draft guidelines are likely to create confusion and fail to further clarify the landscape of vertical merger analysis.[1]

One area of confusion that could readily be addressed is the definition of vertical mergers. Many ordinary fact patterns will leave merging parties with questions of whether their merger can or should be analyzed under the vertical merger guidelines. In particular, some mergers of complements appear to be excluded from the scope of the definition provided in the draft guidelines, despite the competitive issues typically being similar to those of vertical mergers. Other mergers might be argued to have both vertical and horizontal components. The draft guidelines do not particularly acknowledge these issues or provide guidance on how to resolve such situations. Such ambiguity invites debates that could be avoided.

We recognize that, compared to horizontal mergers, vertical mergers involve a much wider range of scenarios and possible merger effects, and therefore it has proven more difficult to propose a single unifying framework for vertical merger analysis. Nevertheless, we believe that the guidelines would benefit from setting out a clear framework of what changes when vertically related firms integrate. This framework should precede, and provide the guiding principles for, the discussion of other more

[1] FTC Commissioner Christine Wilson has offered five questions for public input. See "Concurring Statement of Christine S. Wilson, Publication of FTC-DOJ Draft Vertical Merger Guidelines for Public Comment," File No. P810034, January 10, 2020, available at https://www.ftc.gov/public-statements/2020/01/concurring-statement-commissioner-christine-s-wilson-concerning.

be treated by the agencies. Below we provide some examples that illustrate possible gray areas that the current definition does not cleanly classify as vertical mergers. Providing an all-inclusive definition might be challenging. However, in our view the draft guidelines are too vague to provide useful guidance.

First, it is unclear whether the current definition applies to so-called "diagonal" mergers. Vertical merger guidelines in other jurisdictions have specifically used this term to refer to mergers where the upstream firm provides inputs to the downstream firm's rivals, but not to the downstream firm directly.[2] In the case of the definition used in the draft guidelines, it is instead unclear whether the term "vertical" is meant to apply at the product level or the market level. In other words, does being part of "the same supply chain" refer only to situations in which one of the merging firms already provides specific inputs to the other? Presumably it also applies more generally to the diagonal case, in situations where the merging parties do not themselves trade pre-merger, but where they do operate in vertically related markets. Would it apply even more broadly to potential suppliers, firms that do not supply anyone within the relevant market today but are expected to in the future?

Second, by simply referring to firms in the "supply chain" the definition leaves room for interpreting what it means to have a vertical relationship. The examples in the draft guidelines are clear but they are also understandably simple, focusing on classical vertical mergers. Many real-world settings involve supply chains where the "verticality" is more complicated. How would the agencies treat more nuanced situations? For example, how would they treat relationships where downstream parties do not take ownership of the product? Or how would they treat relationships which lack a strict flow of goods from one level to the other entirely, with suppliers coming together to jointly produce the final product? The DOJ's challenge to Ticketmaster/LiveNation, described in Box 1 below, provides an example of a real-world merger that presented these sorts of issues. Other sorts of complex interrelationships are common in telecommunications mergers, where carriers often rely on interconnections with other carriers so that each can offer ubiquitous reach to their customers.

[2] For more on this and other comparison points, see Peter Davis, Kostis Hatzitaskos, and Bob Majure, "Comparison with the EU Non-Horizontal and the UK Merger Assessment Guidelines," January 2020, available at https://www.cornerstone.com/Publications/Articles/Initial-Comparison-US-Draft-Vertical-Merger-Guidelines-to-EU-and-UK.pdf ("Davis, Hatzitaskos, and Majure (2020)"), at § 2.

Box 1: *The Complaint in U.S. and Plaintiff States v. Ticketmaster Entertainment, Inc. and Live Nation Entertainment, Inc., describes the relationships among the various entities involved in putting on a concert at some length. In ¶ 15 it offers the following diagram, which suggests a flow of production:*

this, consider the following example: a booking platform acquires a large hotel chain that is listed on several booking platforms. Booking platforms are a distribution channel for hotels. Therefore, platforms and hotels can be seen as "operating at different stages of the same supply chain." It is unclear whether the agencies intend for such mergers to be captured within their definition of vertical mergers.

2.2. Mergers of complementary products

The Ticketmaster/LiveNation case discussed in Box 1 is an example where suppliers combine their products to jointly produce a final product for customers. As currently offered, the definition of vertical mergers in the draft guidelines appears to not apply to mergers of firms that provide complementary products or services that are combined not by sellers but by customers, since these products are at the same level relative to customers. Furthermore, the merging parties in such cases are also not "actual or potential competitors" for one another, so the horizontal merger guidelines also would not apply to them.[3]

This is in sharp contrast to the economics literature, which has long recognized that the analysis of mergers among complements is similar to the analysis of vertical mergers. This is because mergers tend to raise the same issues and opportunities whether the complements are combined by suppliers or by the customer – the nature of complements is that the products are more valuable together, regardless of who does the combining. This is recognized by competition authorities in the EU and the UK, where guidelines cover mergers for both vertical and complementary relationships.

This omission means that the draft guidelines may appear to leave out a significant portion of non-horizontal deals. This will be particularly salient for certain industries in which non-horizontal mergers have played an important role in recent years. For example:

- In healthcare, it is unclear whether the current definition in the draft guidelines would cover some of the more common combinations, including the acquisition of physician groups by hospital systems, the combination of physician groups across different specialties, and the acquisition of hospitals and out-patient clinics into larger networks.

[3] Horizontal Merger Guidelines, August 19, 2010, at p. 1 ("with respect to mergers and acquisitions involving actual or potential competitors ('horizontal mergers')").

- In the media industry, it is unclear whether the current definition would cover mergers between broadcasters in distinct geographies served by the same cable companies.
- In intellectual property, the current definition would appear not to cover mergers that bring together portfolios of patents that affect the same industry or that are essential to the same standard set by a standard developing organization.

2.3. Mergers with horizontal and non-horizontal dimensions

Many mergers combine horizontal and non-horizontal dimensions, generating more ambiguity over how these mergers will be evaluated. The horizontal and vertical overlap may arise for at least two reasons. First, not all products can cleanly be classified as either substitutes or complements. Second, sometimes merging parties have a vertical relationship in one relevant market while being horizontal competitors in another relevant market.

We observe many markets where products could be interpreted to be both substitutes and complements. Consider the following example from entertainment media. A consumer typically will watch one TV program or listen to one song at a time, and therefore different programs (or songs) are substitutes. However, the customer also has incremental value from the option to choose between more

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how will the agencies determine whether to investigate a merger under the horizontal merger guidelines or another set of guidelines?

nuance given that the competition is between vertically aligned chains of firms, which can be interconnected in many different, often complicated, ways.

In some cases, firms with

3.2. Key elements of a vertical merger framework

Before delving into specific examples, the guidelines could and should clarify that, as a general matter, there are four elements, or questions, that an investigation needs to address.

First, does the merging party in the related market have the **ability** to influence competition in the relevant market? The answer is yes if the merging party in the "related" market has recognizable and sufficient market power to be able to influence the capabilities of participants in the relevant market to produce or sell their products. Consider the following variant of the draft guidelines' Example 2, presented in Box 2 below.

Box 2: *A monopolist seller of oranges to fi*

Second, does the merging party in the related market have the **incentive** to see that ability used for the benefit of their merging party in the relevant market? To see the importance of this effect, consider the example in Box 3.

Box 3: *Two wholesale suppliers, A and B, supply an input to manufacturers of a consumer product. The manufacturers' technology is specialized, so that it is compatible with the inputs of only one of the two suppliers. Suppose A merges with one of the manufacturers that it supplies (M). Wholesaler A could increase the price it charges to other manufacturers that it supplies. If switching to being supplied by B would be costly to those manufacturers, this may reduce the intensity of competition downstream. Wholesaler A may be more likely to have the incentive to engage in this conduct if the sales lost by these manufacturers are likely to switch to M. It may be less likely to have the incentive to engage in this conduct if lost sales are more likely to go to manufacturers that are supplied by wholesaler B. Wholesaler A may also have a greater incentive to consider such conduct the greater manufacturing margins are relative to wholesaler margins.*

It is tempting to assume that there is a generalizable and monotonic relationship between share in the relevant market and the magnitude of incentives. This might be true, but measuring the magnitude of the incentive to manipulate competition in a market will generally depend on facts specific to each case. Consider, for example, how the various incentives mentioned in Box 3 might be affected by M's share of the manufacturing market. A higher share might mean that sales lost by the competing manufacturers are more likely to switch to M. It might also mean that manufacturing margins are higher if M's share is a signal of how concentrated manufacturing is. Both of these suggest that the merged firm's incentives might be higher (relative to a situation where M's share is lower), but, a higher share for M could also mean that a greater portion of manufacturing margins are already being earned by the merged firm without any manipulation and therefore the merged firm's incentives to raise prices are low.

Third, is the nature of pre-merger **contractual limitations** such that above actions are only made possible as a result of the merger (i.e., merger-specific)?

For better or worse, a merger has an effect only because there are outcomes which cannot be reasonably achieved through contracts alone. The fact that a vertical merger has been proposed at all may suggest that there is some binding limit to what contracts can achieve in a specific case. Identifying what these limits really are will shape predictions about what outcomes are both likely post-merger and merger specific.

A common simplification in the economics literature is to assume that contracts can only have "linear pricing" – that an upstream firm can only charge a constant per-unit wholesale price to downstream firms. This linear-pricing restriction is an easy contractual constraint to incorporate into the math of an economic model. The draft guidelines should differentiate between contract features that are used in practice and those that are used in economic models for analytic convenience.[7]

Finally, what is the **net evaluation** of the merger? Vertical mergers create opportunities to achieve new outcomes by allowing new combinations of incentives and ability that might work in opposite directions.[8]

This final step asks whether at the end of the day, end consumers are likely to experience harm (as opposed to the pro-competitive harm competitors may feel from having to compete with a more efficient rival). It also asks, however, that the agencies establish some way to predict which of potentially alternate outcomes a merged entity is likely to pursue. Consider the example in Box 4.

Box 4: *Assume that a vertical merger is proposed as a way to kick-start a new platform for exchange between participants in both of the merging firms' markets (a pro-competitive outcome). Further assume that this merger also creates an opportunity to foreclose rivals (an anti-competitive outcome). This leaves the agencies having to decide which set of outcomes is more likely than the other – working with rivals as a supplier or driving them from the market – even after proving that the latter would harm competition if it were to occur.*

Behavioral remedies are one vehicle for sorting between the possibilities of what a merged firm is likely to pursue. In the example in Box 4, the agencies could make the development of a new platform more likely by allowing the merged firm to offer commitments not to foreclose or disadvantage rivals. Admittedly, a concern is that it may be difficult to write a contract preventing something from happening when it was too difficult to write a contract to accomplish that outcome pre-merger. With current guidance from at least one agency discouraging behavioral remedies, the

[7] It is worth noting that, moving forward, the draft guidelines may also have an effect on how vertical conduct cases are litigated, just as the horizontal merger guidelines have played a role in horizontal conduct cases (for example, in setting the standard for market definition).

[8] Note that such a net evaluation would be necessary in circumstances where pro-competitive and anti-competitive effects impact the same relevant antitrust market. While we understand this to be a question of law, presumably the agencies would not balance pro-competitive effects in one relevant antitrust market with anti-competitive effects in a different relevant antitrust market, just as they and courts do not generally engage in such balancing in horizontal mergers.

question of how the agencies will sort between alternate paths remains an open one that the current draft guidelines do not address.

4. Market definition

The draft guidelines indicate that "the agencies will normally identify one or more relevant markets in which the merger may substantially lessen competition." They go on to explain that "when the agencies identify a potential competitive concern in a relevant market, they will also specify one or more related products." The implication of this is that a market for the related product need not be defined.

It is worth noting that other jurisdictions follow the convention of defining markets for both of the merging products.[9] Those jurisdictions have many other differences that may make the choice less impractical than it may be in the U.S., but it is worth considering their example in finalizing these guidelines.

Limiting the number of markets that will have to be formally defined before one gets to analyzing competitive effects is an understandably pragmatic approach. It is also consistent with the horizontal merger guidelines increasingly de-emphasizing the need for market definition. Indeed, defining the market for the related product potentially raises issues divorced from the analysis of the merger's competitive impact. The draft guidelines seem to avoid this by simply identifying the ability-laden product as the "related product" without defining a market around it. This might simplify the analysis but raises several issues.

First, the language is not particularly intuitive. A related product could be related in countless ways, and this labeling doesn't convey the idea that it needs to be a product that has ability to influence competition in the relevant market: one of the principles discussed in the previous section.

The related product is defined as "a product or service that is supplied by the merged firm, 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." This rather convoluted definition is unlikely to be helpful for non-specialist readers.

[9] Davis, Hatzitaskos, and Majure (2020), at § 3.

production is strictly 1-for-1, which will not be very helpful in many vertically related industries.

Complementary inputs: Some of the difficulty in establishing an appropriate way to measure usage share is due to the fact that share is not a well-defined concept among complementary inputs. If the whole notion of a chain of production is that products are combined into something more valuable than the sum of its parts, then what share in that value does each contribute? It is easy to conjure up hypothetical scenarios where this ambiguity leads to materially different conclusions. Consider a merger involving a media content provider upstream where, by some measure, the merging firm is just less than 20 percent of a typical MVPD service (e.g., the provider's content makes up 20 percent of the individual programs or minutes of use), but where its content is present in 100 percent of MVPD offerings. Or consider a patent holder with a technology that must be included in every cell phone, but the license to use its patents is only 10 percent of royalties paid by all participants in a prospective relevant market for cell phones.

Current use vs. potential for abuse: As mentioned above, pricing to an existential level may bring into play options outside those observed pre-merger. Conversely, a product may be widely used precisely because it has little value to add and is, therefore, priced only on the basis of competition with the next-best alternative. While the product enjoys high market share today, demand for the product is actually highly elastic and the firm does

5. Market share thresholds

The draft guidelines state that “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.”

The draft guidelines and public comments from agency officials make clear that these thresholds are not offered as strict safe harbors: “In some circumstances, mergers with shares below the thresholds can give rise to competitive concerns. … The purpose of these thresholds is not to provide a rigid screen to separate competitively benign mergers from anticompetitive ones.” Nonetheless, if these thresholds did not convey something about when the agencies are likely to investigate, they would not be in the guidelines.

5.1. Threshold for the relevant market

In the context of the framework set out earlier in section 3, a 20 percent share in the relevant market does not seem to be a useful threshold. The “relevant market” generally represents the incentive side of a merger’s combination between incentives and ability. There is generally no simple relationship between high or low pre-merger shares in the relevant market and greater or lower incentives for post-merger manipulation.

product. A statement acknowledging this key element of a vertical case is more relevant and useful guidance than a safe harbor that may not be binding anyway.

5.2. Threshold for the related product

Aside from the issues of measurement discussed above, there is also a question of whether 20 percent of use in the relevant market is a reasonable threshold. Share in the related market is meant to measure the ability of the merged entity to engage in anticompetitive foreclosure. As stated above, the degree to which this share reflects ability depends heavily on what “used in” means.

For example, if this threshold was intended to mean that a safe harbor does not apply even if three of the four competitors in a relevant market have no current need for the related product (assuming equal sizes, this could be a use share of 25 percent), this threshold implies investigations in a lot of situations where there is no credible expectation that the related product conveys an ability to manipulate competition in the relevant market.

However, as long as the draft guidelines admit the ambiguities discussed above, it is difficult to imagine a higher safe harbor as an accurate predictor of which mergers the agencies will likely examine. In other words, a higher threshold invites even more abuse of the ready availability of misleading measures for how much a product is used in the relevant market. In the sense of two wrongs making a right, this threshold at least does not create as much of a problem as a higher threshold could.

Further, since vertical mergers involve a practical difficulty of forecasting outcomes far from those currently observed – i.e., how might markets react if a merged firm attempted to use a previously untapped ability to manipulate competition and, potentially even to threaten the existence of competitors – current use of the merging firm’s related product may not perform well in capturing these effects. It seems more relevant to articulate the reasons or a rebuttable presumption based on a set of facts where that kind of power is likely to exist.

6. Double marginalization

As set out in the draft guidelines, one consequence of a vertical merger can be that downstream prices charged by the merged entity are reduced as a result of the elimination of double marginalization ("EDM").[12]

However, the draft guidelines seem to award EDM a special status, dedicating a separate section exclusively to this topic. The motivation for this is unclear. In our view, elimination of double marginalization should not, generally as a matter of economics, be treated any differently from other types of efficiency. One may argue that efficiencies as a whole may be more relevant in vertical mergers than in horizontal mergers, but they should still pass the test of merger-specificity regardless of their nature.

Double marginalization is present in models that assume linear pricing but need not arise in models with more general pricing contract arrangements. Specifically, we note that EDM may seem to be a necessary property of particular theories such as foreclosure or raising rivals' costs only because the economic models of those theories commonly assume linear pricing. However, both foreclosure and raising rivals' costs can occur in industries where contracting constraints do not generate double marginalization. It is therefore important that the guidelines distinguish between effects that are driven by common assumptions made in the academic literature and facts that are industry specific.

The draft guidelines do seem to recognize that some fact patterns will make EDM less relevant. However, positioning EDM as a separate section may lead to a disconnect between these fact patterns and the calculation of competitive effects to which they are relevant. This disconnect leads to a confusing situation where EDM is neither fully in the analysis that should include it, nor fully out of the analysis when it is not relevant.

As other contract restrictions may be the reason for a particular vertical merger, the guidelines' special treatment of EDM has to come with acknowledgement that its inclusion depends on the availability of contractual solutions absent the merger – if it can be achieved via contracts that are feasible, then it should not be counted as a pro-competitive effect of the merger. However, other efficiencies may be directly

[12] The name, Elimination of Double Marginalization, refers to the fact that the distorted pricing in the relevant market is the second (hence "double") decision of what margin to apply.

related to the contract restrictions in such a case and should have the prominence in that case that the draft guidelines reserve for EDM.

statement of the fact that economic theory offers no reason to presume, absent a review of the facts, that a vertical merger is likely to be either pro-competitive or anti-competitive.

The standard to meet for a merger not to be challenged is, presumably, that the merger does not “substantially lessen competition” through any anti-competitive strategies pursued by the merged entity, and net of the effects of any efficiencies and the elimination of double marginalization. This is very much left to be inferred by the reader, as the text itself mentions “substantial lessening of competition” only in relation to partial elements of the analysis (e.g. in relation to foreclosure or raising of rivals’ costs, in isolation of any other competitive merger effects).[13]

In addition, there is some ambiguity in the following statement: “The magnitude of likely foreclosure or raising rivals’ costs is not *de minimis* such that it would substantially lessen competition.” This may lead some to conclude that “not *de minimis*” and “substantial” are meant synonymously. Is this the intention, or should “substantial” be interpreted to mean materially above zero? And is this meant to have any implications in terms of the results of any quantitative analysis? It is unclear whether this ambiguity in the draft guidelines is an intentional choice by the agencies, leaving themselves room to maneuver as different cases arise. While this may buy the agencies significant leeway, it means that again the guidelines fail to provide clarity for those making strategic decisions about whether to pursue a transaction.