CPI's North America Column Presents:

FTC Facilitates Lively Debate on the Future of Vertical Merger Enforcement

By Blair Kuykendall
(Dechert)[1]

November 2018

The FTC hosted two panels on November 1st to discuss the future of vertical merger enforcement as part of its "Competition and Consumer Protection in the 21st Century" series. A panel of economists moderated by Bruce Kobayashi, Director of the FTC's Bureau of Economics, discussed the application of economic theories in the vertical-merger context. A second panel, moderated by Bruce Hoffman, Director of the FTC's Bureau of Competition, discussed the prospects of revising agency guidance on vertical mergers.

The hearings featured rich discussion on multiple topics, including several that revealed sharp differences of opinion among the panelists. Among the topics discussed, were: (i) whether and how the 1984 *Non-Horizontal Merger Guidelines* should be revised, (ii) the market structures under which vertical mergers warrant scrutiny, (iii) whether vertical mergers should receive the same level of scrutiny and be analyzed similarly to horizontal mergers, (iv) the merger-specificity of the elimination of double marginalization, a commonly cited efficiency in vertical mergers, and (v) the appropriateness of behavioral remedies for such mergers.

Revision of the 1984 Non-Horizontal Merger Guidelines

Panelists generally agreed that the 1984 Non-Horizontal Merger Guidelines no longer reflect the agencies' approach to vertical merger analysis and that some form of policy direction from the agencies is necessary, but strong debate ensued over the form, content, and timing of any new vertical guidance. Calls for immediate replacement of the guidelines were made by Steven Salop, Professor at Georgetown University Law Center, and Carl Shapiro, Professor of Economics at Berkeley. Paul Yde, partner at Freshfields, noted that he had not referred to the current guidelines in more than ten years, but cautioned against replacing the current guidelines with newer detailed guidelines before economic analysis of vertical mergers had progressed further. Francine La Fontaine, Professor at the University of Michigan, also expressed reservations about revising the 1984 Non-Horizontal Merger Guidelines given the current state of theory and empirical evidence, and that more work was needed in analyzing effects in specific industries and contexts before proposing tests and analyses in a new set of guidelines. Sharis Pozen, VP of Global Competition Law Policy for General Electric, suggested a middle ground. Pozen stated that while a guidelines model may fit in the horizontal merger context, it might be a "round peg for a square hole" in the vertical merger context. She instead advocated for a policy statement to provide guidance to practitioners.

Market Structures Under Which Vertical Mergers Warrant Scrutiny

Salop suggested during his opening remarks that vertical-merger enforcement should be focused on oligopoly markets, and suggested that, in such markets, vertical mergers can have harmful competitive effects similar to horizontal mergers. Although some panelists disagreed with Salop's view of the degree of scrutiny that should be applied to vertical mergers, most agreed that such scrutiny should be limited to oligopolistic markets. Margaret Slade, Professor Emeritus at the Vancouver School of Economics, suggested that much of the economic analyses cited in support of the procompetitive nature of vertical mergers are based on analyses of perfectly-competitive or perfect-monopoly markets, and not analyses of oligopoly markets in which the effects may not be similar.

Comparing Horizontal Merger Analysis to Vertical Merger Analysis

In his opening remarks, Salop suggested that competitive concerns in vertical-merger analysis are not inherently different from those in horizontal-merger analysis. In support of this assertion, he argued that vertical mergers eliminate "indirect" competition between the merging parties in the same way that horizontal mergers eliminate direct competition between the merging parties. Salop explained his view that the upstream merging firm "indirectly" competes with the downstream merging firm by supplying inputs to that downstream firm's rivals, and that this indirect competition can be eliminated by the vertical merger if it gives the upstream firm the incentive to raise prices or cut off the downstream firm's rivals. According to Salop, the implication is that vertical mergers should not be treated fundamentally different from horizontal mergers and should be analyzed similarly under the burden shifting approach articulated in *Baker Hughes* without any heightened showing required of plaintiffs or any presumptions of efficiencies favoring defendants. Consistent with his view of focusing on oligopoly, Salop did, however, suggest that the framework could include safe harbors if the upstream and downstream markets are not concentrated. He also offered certain alternative elements that plaintiffs could rely on to make a prima facie case, given that plaintiffs would be unable to show an increase in concentration as in a horizontal merger.

Other panelists disagreed with Salop's attempt to equate horizontal and vertical mergers. Shapiro, for example, responded that although both horizontal and vertical mergers require a balancing of efficiencies and potential harms, the key difference is that in a horizontal merger the loss of competition is inherent but the realization of efficiencies is not, whereas in a vertical merger, the efficiencies are inherent, in particular the elimination of double marginalization. The key question for Shapiro is whether such efficiencies can be achieved without the vertical merger and whether they outweigh the foreclosure effect. Shapiro also suggested that we not import concepts like concentration metrics from horizontal merger analysis when looking at safe harbors and instead should look more directly to the question of whether the rivals of the downstream merging party will be competitively weakened if they are denied access to the input supplied by the upstream merging party.

Dan O'Brien of Compass Lexecon noted that one problem with focusing on the market power of the merging firms, as would be done in a horizontal merger, is that although market power may be a necessary condition for harm from a vertical merger, the effect of market power is ambiguous because it enhances the potential foreclosure effect but also increases the downward pricing pressure on the merging firms, making it a poor proxy to distinguish a vertical merger resulting in net harm from one resulting in a net benefit. Francine LaFontaine likewise expressed her view that (v)GUPPIs, HHIs and other tools used in horizontal merger analysis are not useful screens in vertical merger analysis. Laura Wilkinson, a partner at Weil, Gotshal & Manges, argued that efficiencies should be afforded more weight in the vertical context than the horizontal context.

Merger Specificity of Elimination of Double Marginalization

Vertically integrated firms often proffer the elimination of double marginalization (EDM) as a merger-specific efficiency. Salop suggested in his opening remarks that EDM is not inevitable in the vertical merger context because of principal-agent dynamics and may not be merger specific if the same elimination of double marginalization could be obtained via contractual relationships. For Salop, the merging firms should be required to explain why they are unable to achieve EDM by contracting independently of the vertical merger.

Kobayashi noted during the panel exchange that Coase's 1937 article, *The Nature of the Firm,* justified the existence of the "firm" based on inefficiencies in bargaining costs associated with contract. Kobayashi suggested that vertical integration by merger would often be superior to contracting, but Salop insisted that the "Coaseian door swings both ways" and listed several historical examples of formerly vertically integrated firms, such as Alcoa, that later found it more advantageous to split into separate companies at the upstream and downstream levels. Shapiro expressed his view, contrary to Salop, that EDM was inherent in vertical mergers but agreed with Salop that EDM may not be merger specific if others in the same industry have been able to achieve the same result through contract. O'Brien noted that absent a merger, upstream firms that possess market power will not contract to transfer their products at marginal cost because such a transfer would dissipate rents. Moreover, LaFontaine argued that there are often incentive problems that make contractual solutions less effective than vertical mergers, and she questioned whether, as a matter of policy, it makes sense for the agencies to hypothesize an alternative contractual arrangement that may require terms that in other contexts could be viewed as an anticompetitive vertical restraint. Salop responded that if the contractual alternative is anticompetitive, then the merger should also be viewed as anticompetitive.

Behavioral Remedies

Panelists were generally supportive of behavioral remedies in the vertical context. Jonathan Sallet, partner at Steptoe & Johnson, noted that behavioral remedies should be "monitorable, measureable and work." He called for more research into the effectiveness of firewalls, arbitration, and non-discrimination requirements. Wilkinson sympathized with the agencies' preference for structural remedies, but expressed her support for creative behavioral remedies that could bring about better results than blocking a merger with procompetitive effects. Gene Kimmelman, President & CEO of Public Knowledge, expressed his support for behavioral remedies in situations where litigation risk is high, but alternative remedies could address the bulk of anticompetitive harm.

---

[1] Blair Kuykendall is an associate at Dechert LLP. Any views expressed in this article are exclusively those of the author.