MODERNIZING THE VERTICAL MERGER GUIDELINES

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I. INTRODUCTION

Several co-authors and I have written articles in the past few years on various aspects of the economics, law, and policy of vertical merger enforcement.[2] I also was able to provide the lead presentation on vertical mergers at the FTC Hearings, and participate on panels with some of the symposium participants. In this short article, I will highlight some key issues which I analyze in more detail in these other articles.

II. SHOULD THE VERTICAL MERGER GUIDELINES BE REVISED?

I start with the easiest issue. The 1984 Vertical Merger Guidelines should be withdrawn and new Guidelines drafted. Industrial organization and merger analysis have dramatically changed in the past 35 years. Neither modern economic analysis nor actual enforcement expressed in consent decrees supports the approach of old Guidelines.[3] To give one example, those old Guidelines pay little attention to the modern analysis of foreclosure.

There are several standard arguments raised against revising the old Guidelines. None of them seem very compelling. I have heard the view that new Guidelines are not needed because everyone knows how to analyze vertical mergers. In light of the controversy expressed at the FTC Hearings and the frequency of superficial analysis, that claim is clearly incorrect. In addition, good government requires that guidelines reflect actual practice. I have also heard the opposite view, that vertical merger analysis is so complicated that useful guidance is impossible. But if the analysis is difficult or complicated, then more guidance is needed, not less. Another rationale is that new Guidelines would lead to more enforcement, which is undesirable. But, this is just ideology overruling analysis. As Judge Leon might say – *Please!*

III. ARE THERE FALSE NEGATIVES?

Advocates for new Guidelines are sometimes asked to identify specific false negative enforcement decisions. However, since investigations are confidential, the transactions can be tough for outsiders to evaluate at the time, and agencies do not provide enough information in their press releases. But after some sodium pentothal, experienced merger lawyers might reveal their surprise that the agencies showed so little interest in the vertical issues, or how quickly the agencies caved, or how easily and unskeptically they assumed elimination of double marginalization and other efficiencies.

2 Jonathan B. Baker, Nancy L. Rose, Steven C. Salop & Fiona Scott Morton, *Five Principles for Vertical Merger Enforcement Policy,* Antitrust 13 (Summer 2019) (forthcoming); Steven C. Salop, *Invigorating Vertical Merger Enforcement* 127 Yale L.J 1962 (2018); Steven C. Salop & Daniel P. Culley, *Revising the U.S. Vertical Merger Guidelines: Policy Issues and an Interim Guide for Practitioners*, 4 J. Antitrust Enforcement 1 (2016).

3 Steven C. Salop & Daniel P. Culley, *Vertical Merger Enforcement Actions: 1994–July 2018*, Geo. U. L. Ctr. (Aug. 23, 2018).

I recently analyzed the press releases for two recent FTC clearances (by 3-2 votes) of vertical mergers to determine if either might have been false negatives, and I concluded that *Staples/Essendant* may have been one.[4] Another notable false negative that I studied – *Jeld-Wen/CMI* – was revealed last year.[5] In 2002, the DOJ cleared that merger, which was horizontal as well as vertical, but the concerns involved vertical foreclosure. Jeld-Wen and Masonite accounted for more than 80 percent of interior molded door sales. Jeld-Wen, Masonite, and CMI also supplied almost all the doorskins used by unintegrated door manufacturers as inputs for molded doors. Two years later, Masonite publicly announced that it no longer would sell doorskins to these independent manufacturers. In response, Jeld-Wen sent Masonite's press release to Steve's and Sons, one of the largest independents, and suggested that it be discussed further. Jeld-Wen then worsened terms to contract customers and raised doorskin prices to customers without contracts. Jeld-Wen and Masonite then also raised their door prices. This is an example of the "Frankenstein Monster" anticompetitive scenario identified in Krattenmaker & Salop[6] and modeled in Ordover et. al.[7] Jeld-Wen also said that it would not renew Steve's contract when it expired, a contract signed shortly before Jeld-Wen announced the CMI acquisition. Steve's complained to the DOJ, which took no action. Steve's then brought a private antitrust case, which it won in 2018 in a jury trial with Carl Shapiro as its economic expert. Judge Payne has ordered divestiture of CMI.[8]

Another possible way to identify false negatives is through post-merger econometric studies. Rigorous and reliable econometric studies face a number of difficulties, including lack of access to relevant data, simultaneous confounding market changes, as well as the usual econometric problems. However, during the past decade, a significant number of econometric studies using modern methods have identified the adverse effects of specific vertical mergers.[9] Econometrics may not be definitive, of course. For example, the study by Jonathan Baker and his FCC colleagues concluded that the *News Corporation/DirecTV* merger led to higher prices.[10] Testifying for AT&T, Dennis Carlton's study concluded the opposite.

IV. ARE THERE DIFFERENT INHERENT EFFICIENCIES AND MARKET POWER HARMS IN HORIZONTAL VERSUS VERTICAL MERGERS?

It is sometimes claimed that vertical and horizontal mergers are inherently different, even in the oligopolistic markets where enforcement typically occurs. It is said that models show that there are inherent efficiencies from vertical mergers and no inherent market power harms, and *vice versa* for horizontal mergers. The contrast between the Cournot-substitutes and Cournot-complements models is the classic example. At the FTC Hearings, Dan O'Brien referred to such "canonical models." Of course, the implications of even these famous Cournot models are less clear cut. As pointed out by Ronald Coase 80 years ago, vertical merger efficiencies often can be achieved *by contract* rather than vertical integration *by ownership*.[11] The famous Salant, Switzer & Reynolds model showed that horizontal mergers in simple Cournot-substitutes markets are not profitable, absent efficiencies.[12] This latter result would be said to imply that horizontal mergers of Cournot substitutes have inherent efficiencies.

4 Steven C. Salop, *Analyzing Vertical Mergers to Avoid False Negatives: Three Recent Case Studies*¸ Antitrust (Summer 2019) (forthcoming). The three mergers were *Staples/Essendant*, *Fresenius/NxStage*, and *Jeldwen/CMI*.

5 *Id.*

6 Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs To Achieve Power over Price*, 96 Yale L.J. 209 (1986).

7 Janusz A. Ordover, Garth Saloner & Steven C. Salop, *Equilibrium Vertical Foreclosure*, 80 Am. Econ. Rev. 127 (1990). The Frankenstein Monster describes a scenario in which the upstream competitor(s) of the merging firm in a concentrated input market gain the power to raise their own prices in response to the foreclosure behavior (e.g. a price increase or refusal to sell) by the upstream merging firm, thereby raising the profitability of the foreclosure. The FTC majority similarly may have overlooked this effect in its analysis of the Staples/Essendant merger. See Salop, *supra* note 4.

8 See *Steves & Sons, Inc. v. JELD-WEN, Inc.*, No. 3:16-CV-545 (E.D. Va. Dec. 14, 2018).

9 *See* Salop, *supra* note 2 at n.103; Baker et. al, *supra* note 2. Older econometric studies gave mixed results and a number of them were unable to reliably evaluate all the relevant competitive effects. Nor could they typically evaluate whether or not any efficiency benefits were merger-specific.

10 Jonathan B. Baker et al., *The Year in Economics at the FCC, 2010-11: Protecting Competition Online*, 39 Rev. Indus. Org. 297 (2011).

11 Ronald H. Coase, *The Nature of the Firm*, 16 Economica 386 (1937).

12 Stephen W, Salant, Sheldon Switzer & Robert J. Reynolds, *Losses from Horizontal Merger: The Effects of an Exogenous Change in Industry Structure on Cournot-Nash Equilibrium, 98* Quarterly J. Econ. *185 (1983).*

Even putting aside these general results, the "vertical/good - horizontal/bad" characterization (ported from Orwell's *Animal Farm* into antitrust by Jon Baker) is also not true across all vertical merger models. O'Brien's canon likely includes the famous Spengler article,[13] but perhaps not Coase's. The seminal Hart & Tirole model exhibits anticompetitive effects and no efficiencies.[14] The same is true for the Ordover, Saloner & Salop model.[15] These two articles apparently are not among O'Brien's sacred texts. Moreover, if "canonical" models of horizontal mergers showing inherent anticompetitive effects and no efficiencies were to be so worshipped, then horizontal mergers in unconcentrated markets also would be treated as inherently anticompetitive, rather than typically escaping agency scrutiny with a safe harbor.

There are similar inherent market power concerns that arise from vertical mergers in oligopoly markets just as they arise from horizontal mergers. Consider the common vertical merger scenario where the upstream merging firm was competing in the pre-merger world to sell inputs to the unintegrated downstream firms that compete with its future downstream merger partner. In this scenario, that upstream firm was effectively a pre-merger "partner" of these unintegrated downstream competitors. After merging, the upstream firm would obtain foreclosure incentives to raise their costs and prices. This is analogous to the price-raising effects of a hypothetical horizontal merger between the downstream merging firm and its competitors. Indeed, it is analytically similar if not equivalent to a standard unilateral effects model.[16] Thus, there is an inherent horizontal effect even in this common vertical merger scenario.

Neither can one say that foreclosure would be necessarily irrational. In an interesting new article based on a very large data set, Boehm and Sonntag find that upstream suppliers are more likely to break relationships with their customers when they merge with those customers' competitors, relative to when they merge with non-competitors.[17] Both vertical and horizontal mergers can also facilitate coordination. This can involve removing a maverick, softening competition, or exchanging information. These collusive concerns in vertical mergers also should not be ignored.

Vertical mergers certainly can lead to efficiencies. But it is important to note that there also are potential barriers to success, including failure to understand the target's business or appreciate its culture. Judge Leon was convinced that the *AT&T/Time Warner* merger would achieve the claimed efficiencies. But it is interesting that both Time Warner and DirecTV (AT&T's satellite distribution entity) had previously been part of vertically integrated firms but then were *dis-integrated*. This Time Warner split off from its distribution entity, Time Warner Cable, in 2009. News Corporation (Fox) acquired a controlling (minority) interest in DirecTV in 2003 but then sold it off in 2006 to Liberty Media (another smaller program owner), which then sold it off to AT&T. history does not indicate substantial vertical merger efficiencies.[18] *Go figure!*

It is also important to credit only efficiency claims that are not actually anticompetitive effects in disguise. For example, suppose that the downstream merger partner wants to gain earlier access to the innovative new products of a potential upstream merger partner, products which currently are made available to all the downstream competitors on an equal basis at the same time. If the upstream firm sells critical input products and the downstream rivals lack equally good substitutes, then earlier access for one firm means delayed access for others. It is not at all clear why this market change would be efficient or benefit consumers.[19]

13 Joseph J. Spengler, *Vertical Integration and Antitrust Policy*, 58 J. Pol. Econ. 347 (1950).

14 Oliver Hart & Jean Tirole, *Vertical Integration and Market Foreclosure*, 21 Brookings Papers on Economic Activity (Microeconomics) 205 (1990).

15 Ordover et. al., *supra* note 7.

16 For details, see Serge Moresi & Steven C. Salop, *vGUPPI: Scoring Unilateral Pricing Incentives in Vertical Mergers*, 79 Antitrust L.J. 185 (2013); Steven C. Salop, *Revising the Vertical Merger Guidelines*, FTC Hearings Presentation (November 1, 2019) at Slides 12-15; Baker et. al., *supra* note 2.

17 Johannes Boehm & Jan Sonntag, *Vertical Integration and Foreclosure: Evidence from Production Network Data* (Dec. 8, 2018).

18 In light of their structures and sizes, both of the previous vertically integrated firms would have faced impediments to profitable foreclosure.

19 The 2016 proposed (and abandoned) *LAM/KLA* merger may have raised this type of issue. *See Lam Research Corp. and KLA-Tencor Corp. Abandon Merger Plans* (DOJ Press Release, October 5 2016). I consulted with a critic of this proposed merger. The recently abandoned acquisition of Gatan by Thermo Fisher also may have raised this type of concern.

V. HOW SHOULD ELIMINATION OF DOUBLE MARGINALIZATION BE TREATED?

The elimination of double marginalization ("EDM") is generally cited as an inherent efficiency benefit from vertical mergers in oligopoly markets. This is not always the case, because intra-firm supply may not occur. Atalay, Hortaçsu & Syverson find that almost half of the upstream divisions of potentially vertically integrated firms do not provide inputs to their downstream divisions.[20] Vertical mergers may offer the potential to achieve efficiency benefits from EDM, but this does not justify a highly permissive enforcement policy that *presumes* large EDM benefits.

First, EDM may not be merger-specific. Coase's point that efficiencies might be achieved *by contract* rather than requiring a vertical merger applies to EDM as well. EDM might be achieved with quantity-forcing, take-or-pay provisions or non-linear pricing contracts. The standard Nash bargaining model typically assumes a lump sum payment in order to maximize joint surplus, not a per unit price. Second, EDM benefits are mitigated when incremental downstream sales are diverted to the downstream merger partner from other downstream customers who purchase inputs from the upstream merger partner.[21] Third, the downstream merging firm has countervailing incentives to raise its price to drive input sales to its upstream partner.[22] Finally, EDM effects may not outweigh the upward pricing pressure from the raising rivals' cost/foreclosure effects, including the Frankenstein Monster, as well as from coordinated effects, or both.

If EDM is merger-specific and otherwise cognizable, it should be credited. But merger-specificity must be proved by the merging parties, not simply assumed. In *AT&T/Time Warner*, it seemed that referring to "bargaining frictions" was considered sufficient evidence that EDM-contracts were not possible. *Poppycock!* Bargaining frictions are ubiquitous, including in merger negotiations. Robert Bork's famous quote might be mirrored here. *If the only justification for EDM being merger-specific is the existence of bargaining frictions, then the agencies would do better by introducing the parties to a contract mediator or arbitrator than by permitting an otherwise anticompetitive merger*.

In *AT&T/Time Warner*, pre-merger prices exceeded variable costs. But that fact alone does not prove merger-specificity absent evidence that the merging firms specifically tried and failed to negotiate an EDM contract. It is possible that MFNs might have prevented a non-merger EDM contract, as suggested by Hovenkamp & Sukhatme[23] and myself.[24] But this explanation itself raises two questions. First, AT&T was the largest MVPD programming purchaser and MFNs normally do not constrain the largest buyer. Second, if widespread MFNs systematically would prevent price discounting across the market, then it follows that the MFNs likely are anticompetitive. In that case, they should be enjoined and prohibited by the DOJ and FCC. It makes no sense for an agency to permit an otherwise anticompetitive merger as a work-around for anticompetitive MFNs that the firms voluntarily negotiated.

VI. WHAT PRINCIPLES SHOULD GOVERN APPROPRIATE VERTICAL MERGER POLICY?

My co-authors (Jonathan Baker, Nancy Rose & Fiona Scott Morton) and I recommend that vertical merger enforcement policy satisfy some important principles.[25] We recommend that the agencies should not presume that vertical mergers benefit competition on balance in the oligopolistic markets that typically prompt agency review, nor should they set a higher evidentiary standard based on such a presumption. We also recommend that the agencies evaluate claimed efficiencies resulting from vertical mergers as critically as they do for horizontal mergers. The agencies also should require the parties to show that these efficiencies are verifiable, merger-specific, and sufficient to reverse the potential anticompetitive effects. We recommend that the agencies analyze the full range of anticompetitive theories, just as they do for horizontal mergers. This would include paying close attention to potential vertical issues that arise in horizontal mergers.

20 Enghin Atalay, Ali Hortaçsu, & Chad Syverson, *Vertical Integration and Input Flows*, 104 Am. Econ. Rev. 1120, 1127 (2014).

21 See Moresi & Salop, *supra* note 15.

22 *Id.*

23 Erik Hovenkamp & Neel Sukhatme, *Vertical Mergers and the MFN Thicket in Television,* CPI Antitrust Chronicle (2018).

24 Steven C. Salop, *The AT&T/Time Warner Merger: How Judge Leon Garbled Professor Nash*, 6 J. Antitrust Enforcement 459, 468 (2018).

25 Baker et. al., *supra* note 2.

I should add that these principles also can be applied by the courts in setting the legal standards for vertical mergers. The *27 Scholars* amicus brief to the D.C. Circuit in *AT&T/Time Warner* generally made similar recommendations for judicial analysis.[26] These scholars included Herbert Hovenkamp, Joseph Stiglitz, A. Douglas Melamed, and Michael Whinston, among others. This approach is consistent with Section 7, which applies to vertical mergers as well as horizontal mergers. Its overarching "incipiency" standard places additional weight on avoiding false negatives, including under-deterrence. This approach makes sense since merger enforcement is predictive and mergers are permanent. It is well-accepted that oligopolistic markets do not automatically or rapidly self-correct to the achievement of market power, particularly where exclusionary conduct creates or increases entry barriers.[27]

VII. SHOULD THERE BE SAFE HARBORS AND ANTICOMPETITIVE PRESUMPTIONS?

My co-authors and I also recommend that any safe harbors should be rebuttable and applied only when both markets are unconcentrated. We also recommend that the agencies consider adopting rebuttable anticompetitive presumptions when certain factual predicates are met. I will highlight only one of them here. We recommend that the agencies consider a rebuttable "dominant platform presumption" that would apply to a vertical (or complementary product) merger if at least one of the merging firms is a dominant platform. This presumption in principle might be applied to Google, Facebook, Amazon, and others. The other presumptions are discussed in our longer article.

VIII. CONCLUSIONS

The claim that vertical mergers are invariably efficient and procompetitive is a vestige of outdated economic analysis. Oligopoly, high concentration, and market power are common today, as are technological and network-effects entry barriers. In our modern economy, vertical and complementary product mergers present heightened concerns. Vigorous vertical merger enforcement is necessary to protect a vibrant competitive process, innovation, and consumer welfare.

26 For the full list of the 27 scholars, see Brief for 27 Antitrust Scholars as Amici Curiae in Support of Neither Party, United States v. AT&T, No. 18-5214 (D.C. Cir. filed Aug. 13, 2018) (No. 18-5214).

27 Jonathan B. Baker, *Taking the Error Out of "Error Cost" Analysis: What's Wrong with Antitrust's Right,* 80 Antitrust L. J. 1, 17–23 (2015).