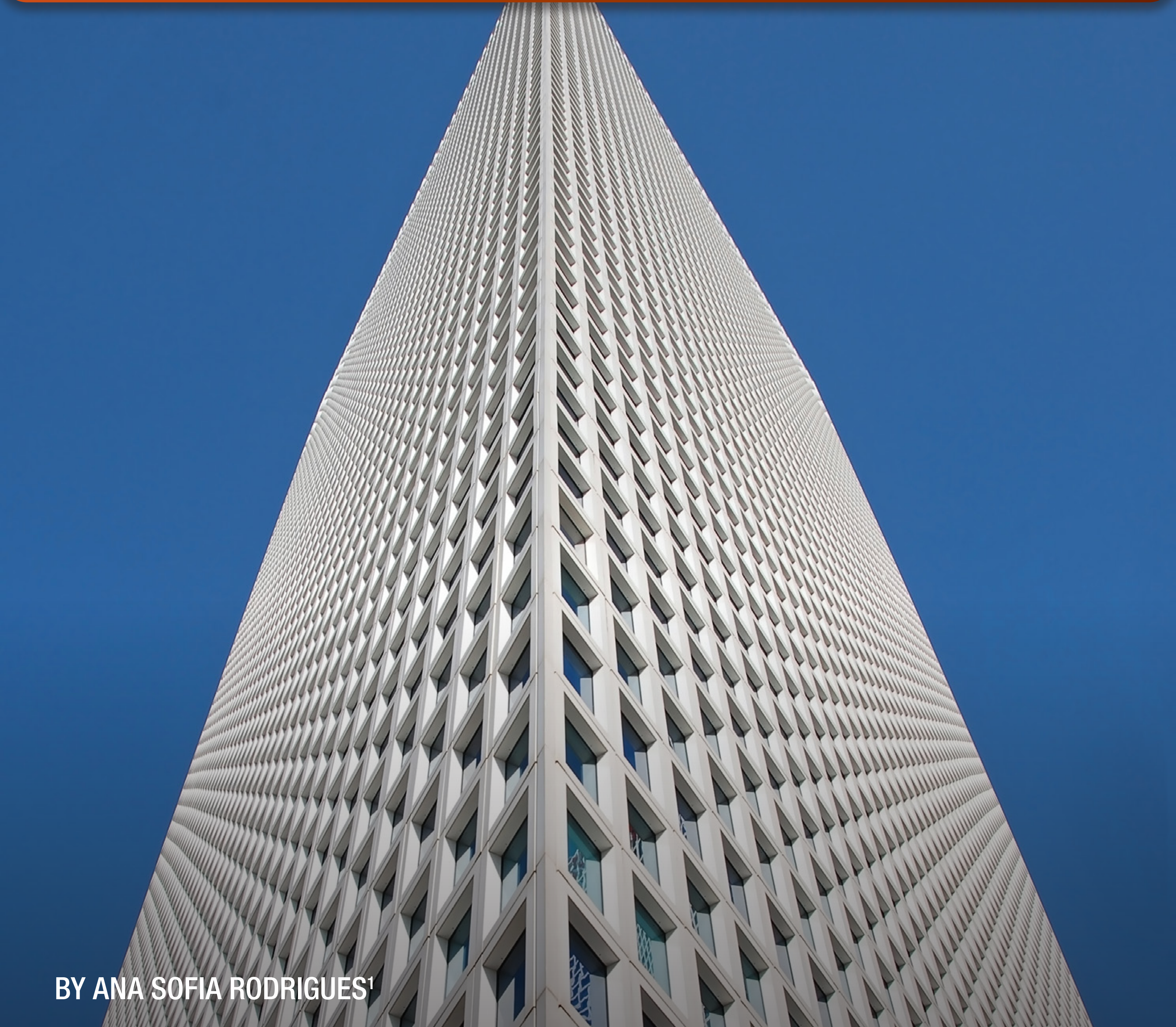
HIGHLIGHTS OF THE MUCH-AWAITED U.S. VERTICAL MERGER GUIDELINES



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I. INTRODUCTION

On June 30, 2020, the DOJ and the FTC issued the final version of the long awaited new Vertical Merger Guidelines ("VMG"). The guidelines aim at providing "*the principal analytical techniques, practices, and enforcement policy for vertical mergers.*"[2]

The document replaces the 1984 Non-Horizontal Merger Guidelines ("NHMG"), which did not experience any revision for over three decades. This is in sharp contrast with the Horizontal Merger Guidelines, which were reviewed three times (1992, 1996, and 2010), since the 1984 document was issued.

With few exceptions, there was wide consensus that the 1984 NHMG were outdated and in need of revision. The gap between the old guidance and the economic theory is obvious when recalling that the "post-Chicago" literature on vertical integration arose around the time the 1984 NHMG were issued.[3]

Drafting guidelines is a challenging process and more so for vertical mergers because of the interdependence between harms and benefits. That is not to say that vertical mergers cannot do any harm or that they should be presumed pro-competitive and social welfare increasing. The new VMG rightly stay away from pro-competitive presumptions regarding vertical mergers.

Most notably, the new VMG are issued in the aftermath of the District Court and the Appeals Court decisions on the first vertical merger litigated in the US, in the last 40 years – the *AT&T/Time Warner* case. These decisions raise important points of discussion regarding several key aspects of vertical mergers´ competitive assessment – from the treatment of the elimination of double marginalization ("EDM") to the bargaining models that assist the assessment. The VMG must have inevitably been influenced by the unfolding of *AT&T/Time Warner*.

There are, however, further relevant trends that surround the release of the new VMG. I would highlight, in particular, the digitalization of the economy and the debate regarding competition law enforcement in labor markets.

In what follows, I discuss some highlights of the new VMG, with the backdrop that I just described.

[2] Press Release, Draft vertical merger guidelines, public-comment.

[3] E.g. Salop & Scheffman, (1983), "*Raising Rivals' Costs: Recent Advances in the Theory of Industrial Structure*," American Economic Review, Vol. 73(2). Salop & Scheffman (1987), "*Cost-raising Strategies*," Journal of Industrial Economics Vol 36 (1); and Salinger (1988), "*Vertical Mergers and Market Foreclosure*," The Quarterly Journal of Economics, Vol 103 (2).

II. HIGHLIGHTS OF THE NEW VMG

A. Elimination of Double Marginalization – "Special" Efficiencies?

The first topic I would highlight concerns EDM.

EDM results from internalizing a pricing externality. When EDM is present, it should be treated as flowing from the alignment of incentives between the merged entity upstream and downstream divisions. On this regard, the new VMG state that "*it arises directly from the alignment of economic incentives between the merging firms.*"[4]

However, EDM needs not to follow from vertical integration in all industries. EDM depends crucially on modelling assumptions, such as linear pricing, but need not be present in models with more general pricing rules. There are several market circumstances in which EDM would not result from a merger.[5] Thus, EDM cannot be treated as an automatic inevitability of mergers in all industries.

The most relevant issue regarding EDM is on merger specificity. EDM can sometimes be achieved through contractual arrangements with non-linear pricing, such as two-part tariffs. The draft VMG acknowledged this explicitly, stating that "[t]*he effects of the elimination of double marginalization may be lower if, prior to the merger, the merging parties already engaged in contracting that aligned their incentives*."[6] In the final version of the VMG, however, this statement was eliminated, and the agencies focus the guidance on evidence that may be relevant regarding EDM's merger specificity, such as "*existing contracting practices*" and "*contracts between similarly situated firms in the same industry and contracting efforts considered by the merging firms*."

Just like with other merger efficiency claims, the burden of demonstrating EDM lies on the merging parties. However, the new VMG also state that the agencies "*do not, however, reject the merger specificity of the elimination of double marginalization solely because it could theoretically be achieved but for the merger*."[7] Can this read as, if no incentive-aligning contracts exist pre-merger, by default, EDM is presumed to be merger specific? Is this a presumption that flips the burden of proof on to the agencies?

This aspect of the VMG is probably the most debated in what regards EDM. In particular, it raises important questions as to the practical treatment of EDM by the US agencies. It also touches upon a topic that has triggered different views within the competition community. Most notably, Steven Salop is among those arguing for EDM as deserving no "special" treatment in terms of burden of proof *vis-à-vis* other cognizable efficiencies. On the other side, with Geoffrey Manne among the most vocal, are those claiming that the latter approach abstracts from practical realities concerning bargaining environments and overestimates the outcomes of contracting.[8]

But, in fact, we know that the failure to reach EDM in the pre-merger world does not necessarily mean that contractual agreements are out of reach as an alternative to a vertical merger. The burden of demonstrating merger specificity of EDM should thus fully remain on the merging parties' shoulders.

[4] New VMG, page 11.

[5] See Hatzitaskos, Majure, McDowall, & Nevo, "*Comments on the January 2020 Draft Vertical Merger Guidelines*," February 19, 2020; and Baker, Rose, Salop & Morton, "*Recommendations and Comments on the Draft Vertical Merger Guidelines*," February 24, 2020. See also, Slade and Kwoka (2020), "*Second Thoughts on Double Marginalization*," Antitrust, Vol. 34 (2).

[6] Draft VMG, page 7.

[7] New VMG, page 12.

[8] See, for example, the Comments of ICLE on the Draft Vertical Merger Guidelines.

B. (Digital) Conglomerates: The (Shy?) Inclusion in the Final Version of the VMG

One of the most noticeable aspects of the draft VMG was the absence of an explicit reference to complementary products mergers. The draft VMG coverage was, or could be seen as being, limited to mergers concerning vertically related products. Indeed, in the draft VMG, related products were 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."*[9]

This absence triggered several comments during the public consultation naming this as a big miss in the draft VMG. As a result, contrary to the draft document, the final text explicitly states that the guidance applies to a "*range of non-horizontal transactions*," including "*diagonal*" mergers, thus staying away from the narrow applicability to vertical deals.[10]

The introduction of other non-horizontal mergers in the scope of the VMG is certainly warranted, particularly in the context of the digital economy. Indeed, if one could name only one advent as the most prominent since the VMG were first issued in 1984 that would have to be the digitalization of the economy. But the main question is whether the VMG provide guidance as to the specificities of conglomerate mergers in the digital era.

Complementarities, network effects, economies of scope and sharable inputs are all relevant in the digital economy. The main source of competition left to discipline large digital conglomerates that are otherwise shielded from competition is often that of potential entry. Dominant platforms may seek to protect incumbency profits through pre-emptive mergers aimed at eliminating potential competition.

As a result, conglomerate theories of harm have gained an added relevance in the context of the digital economy. Novel theories of harm have developed (see, e.g. Bourreau & de Streel, 2019).[11] In digital markets, an adjacent product or service can often be a privileged, or the only, entry point to an otherwise closed digital platform or ecosystem. Digital conglomerates may pursue a merger policy driven by strategic incentives to eliminate threats to the incumbent platform or ecosystem through envelopment of their small competitors. Furthermore, the interest of these new theories of harm has gained added thrust with empirical evidence showing that circa 60 percent of all the firms acquired by Google, Amazon and Facebook were four-year-old or younger when they were acquired by these digital giants (Argentesi et al, 2019).[12]

Given that these novel theories of harm are not addressed in the guidelines, the approach of the agencies to these issues will have to emerge from decision making.

C. A Closure to the AT&T/Time Warner Saga?

The new VMG were issued a little over a year on from the U.S. Court of Appeals decision upholding the District Court ruling, signed by Judge Leon, in favor of the defendant. The decisions cleared the way for the *AT&T/Time Warner* deal to go ahead. The merger had been challenged by the DOJ on the grounds of a raising rivals' costs theory of harm.

Among the several points of criticism laid down on Judge Leon's ruling regarding the case put forward by the DOJ, there are two that are particularly relevant from the point of view of the fundamental economic principles underlying vertical mergers' competition assessment.

The first point has to do with the treatment given in the ruling to the extent in which profits from the upstream and downstream divisions are integrated to govern strategic decisions. In particular, the ruling relies on statements from business representatives to conclude that the downstream division's (DirectTV) profits would not be considered by the upstream division (Turner) of the merged entity, thus softening concerns with the raising rival's costs theory of harm. However, by the same token, the rational for EDM would be broken, as the incentive alignment that may follow from vertical mergers would not occur. But the ruling does not extract the necessary consequents of accepting that argument for the treatment of EDM, leading to an inconsistency.

[9] Draft VMG, page 2.

[10] New VMG, page 1.

[11] Bourreau & de Streel (2019), "Digital Conglomerates and EU Competition Policy."

[12] Argentesi, Calvano, Buccirossi, Duso, Marrazzo & Nava (2019), "*Merger Policy in Digital Markets: An Ex-Post Assessment*" CESifo WP No. 7985.

The view that vertically integrated entities have no regard for joint profits is at odds with the economic literature and with the empirical evidence. Crawford et al (2018),[13] for example, estimate, with a structural model of the multichannel television industry, that a vertically integrated distributor internalizes $0.79 of each dollar of profit accrued by the upstream vertically integrated channel, and that regional sports networks fully account for the gains, to the downstream division, of denying access to content to rival distributors.

The second point has to do with the dismissiveness regarding the Nash bargaining model used by the DOJ to represent the negotiations between content providers and content distributors. In particular, the ruling deems the threats of blackouts, and thus their role in leveraging the ability of the content provider to obtain more favorable terms from the negotiation, as not credible because of the costs a long-lasting blackout would bring to the content provider.

These two points, and how they abstract from well-established economic theory, are illustrative of the relevance of guidance and the need for pedagogy, and intensified the calls for an update of merger guidance. And, indeed, both of these issues are addressed in the final version of the VMG.

The interdependence between EDM and the raising rivals' costs theory of harm are explicitly addressed in the new VMG. In particular, the VMG now state that EDM arises from incentive alignment and that "*the same source drives any incentive to foreclose or raise rivals' costs*," such that the evidence to assess EDM and the harm resulting from the merger overlap substantially.[14]

The draft version of the guidelines was notoriously scant on bargaining theory. However, the topic was densified in the final version of the new VMG. The document, however, does not explicitly address the logic of threat points, and that they need not have to materialize to provide leverage in a bargaining negotiation.

The question surely is whether the guidelines are enough to resolve the scars left by the *AT&T/Time Warner* rulings. And I believe that, while they are a key step in cementing a well-established framework for the analysis of vertical mergers, the discussion would certainly benefit from an ex-post assessment of *AT&T/Time Warner*. Maybe this would bring closure to the saga.

D. A Side Note on Labor Markets

Competition in the labor market has been in the spotlight of competition policy in the U.S. in recent years. The interest on the macroeconomic implications of market power has been prompted by the influential papers by De Loecker & Eeckhout (2017) and Autor et al. (2020),[15] associating the trends of increasing concentration and the decline in the labour share of GDP.

Furthermore, a number of papers (e.g. Marinescu & Hovenkamp, 2019[16]) have been published claiming that merger enforcement is overly focused on the supply side of products and services markets, and rarely on competition concerns driven by concentration in the buyer side of the market, in particular in labor markets.

At the agencies level, FTC Commissioner Phillips stated that "*the FTC has now made it standard practice to screen for harms from enhanced labor monopsony power as part of every merger review. This process has just begun.*"[17]

This U.S. trend is discernible in the public consultation launched by the agencies to the VMG. Among the comments submitted in the public consultation to the VMG are those of the major American labor unions. The unions argued that the draft ignored harm to workers, and called for labor market implications of mergers to be factored into the merger review.

[13] Crawford, Lee, Whinston & Yurukoglu (2018), "*The welfare effects of vertical integration in multichannel television markets*," Econometrica, Vol 86 (3).

[14] New VMG, page 11.

[15] Autor, Dorn, Katz, Patterson & Van Reenen (2020), "*The Fall of the Labor Share and the Rise of Superstar Firms*," The Quarterly Journal of Economics, Vol 135 (2).

[16] E.g. Azar, Marinescu, Steinbaum & Taska (2018), "*Concentration in US Labor Markets: Evidence from Online Vacancy Data*," Labor Economics, Vol 66; Marinescu & Hovenkamp (2019) "*Anticompetitive Mergers in Labor Markets*"Indiana Law Journal Vol 94 (3).

[17] Prepared Statement of Commissioner Noah Joshua Phillips before the U.S. House of Representatives on Antitrust and Economic Opportunity: Competition in Labor Markets.

The strengthening of labor monopsony power is, however, more of a potential concern in horizontal mergers than in vertical deals. There is no reference in either the draft or the final version of the VMG to labor markets. It is however noteworthy the addition in the final version of the guidelines comparing the harm from "*monopsony power*" to that of market power in the sellers' side, and clarifying that the agencies use an analogous framework for assessing vertical mergers that strengthen the market power of buyers.

III. FINAL REMARKS

The vertical merger guidelines were issued in the midst of several calls for an invigorated merger enforcement. The public discussion that followed the release of the draft version in January 2020 was prolific and played an important role in shaping the final version of the document.

The document closes the gap between the U.S. agencies' assessment of vertical mergers and the guidance made available to the stakeholders. It incorporates the agencies practices for the recent past, but it does not uncover the veil on the approach to new challenges, in particular regarding the digital economy.

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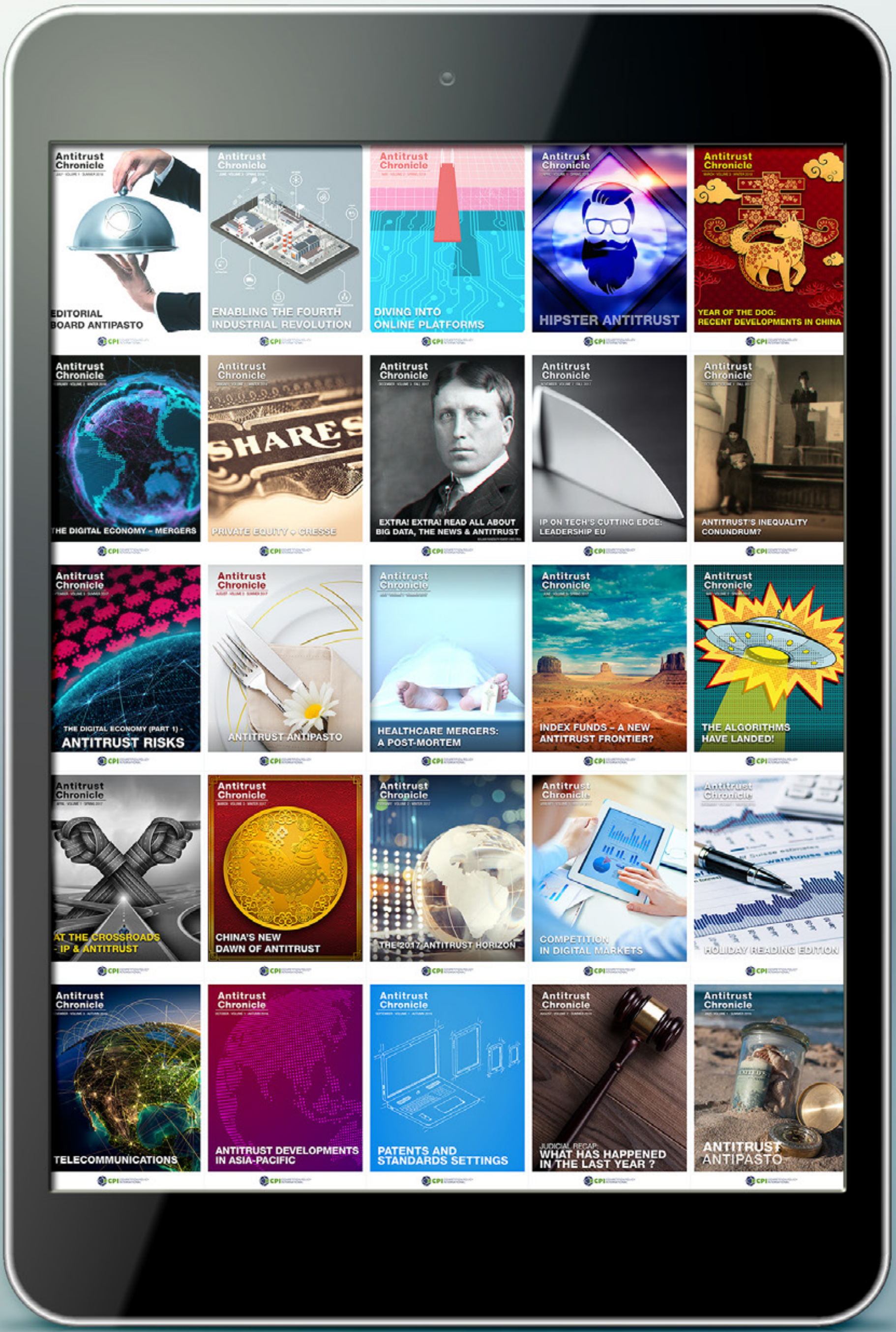
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