DOJ/FTC Joint 2020 Vertical Merger Guidelines: Comments of CAP Economics

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February 26, 2020

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The U.S. Department of Justice Antitrust Division and Federal Trade Commission ("FTC") jointly issued draft Vertical Merger Guidelines ("VMG") on January 10, 2020 with a request for comments submitted by February 11, 2020, later extending the deadline to February 26, 2020. Vertical Merger Guidelines are an important initiative of the agencies, advising antitrust practitioners as well as businesses, investors and the courts regarding the Agencies' enforcement policy in this important category of mergers. The draft VMG focus attention on a limited subset of the vertical theories that the Agencies have considered during the almost 40 years since the last published guidelines covering vertical mergers. Nonetheless, the Agencies retain the flexibility to pursue other theories of harm that may arise in the course of investigations of specific mergers. In the comments below, we urge an expansion of the VMG to include coverage of other well-developed theories of vertical effects that have resulted in enforcement actions in recent mergers, so that parties and counsel can better evaluate risks of, and assess potential burdens for, prospective mergers. Accordingly, this note provides comments in three areas, namely, (I.) vertical mergers and horizontal effects, (II.) likelihood of coordination in raising rival costs (RRC), and (III.) review of customer complaints.

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I. VERTICAL MERGERS AND HORIZONTAL EFFECTS

As defined in the draft guidelines and recent investigations, "vertical mergers"[1] include transactions combining vertically integrated acquiring firms with target firms that operate at one or more different stages of the supply chain in which the acquiring firm operates. Whereas in a pure vertical merger the acquiring firm and the target firm each operate at different stages of the same supply chain, many proposed mergers involve not only vertical relationships but also horizontal overlaps, i.e., the merging parties operate lines of business at the same stage of a supply chain and other lines of business at different stages of a supply chain.[2] Vertical mergers involving firms that are already vertically integrated may raise concerns over vertical effects as well as horizontal effects, as the Agencies' enforcement record demonstrates.[3] Therefore, the VMG could bear clarification that (1.) proposed vertical

[1] According to the draft VMG, "Vertical mergers combine firms or assets that operate at different stages of the same supply chain (note 2, p. 1)."

[2] For example, in a recent merger involving CVS Health and Aetna the parties were both suppliers of Medicare Part D Prescription Drug Plans, while Aetna supplied health insurance plans to businesses and consumers in certain regions of the country (CVS did not), and CVS operated retail pharmacies (Aetna did not). *See*, Complaint (ECF #1), *United States et. al. v. CVS Health Corp. and Aetna Inc.*, Case 1:18-cv-02340-RJL (D.D.C. 10/10/2018). Both Aetna and CVS operated other business lines not discussed here. Also, in 2018, Sycamore Partners, which controlled Staples, a supplier of office products at retail to consumers and businesses, announced its plan to acquire Essendent, a wholesale distributor of office suppliers. *In the Matter of Sycamore Partners II, L.P., Staples, Inc. and Essendant Inc.*, Statement of Chairman Simons, Commissioner Phillips, and Commissioner Wilson.

[3] In the CVS/Aetna transaction, the Antitrust Division investigated concerns over input foreclosure and customer foreclosure, but focused enforcement on the horizontal overlap in Medicare Part D Prescription Drug Plans. See complaint, at note 2. The Staples/Essendent transaction was investigated by the FTC, with the majority of Commissioners inferring that "... the only competitive concern arising out of this transaction that is supported by the evidence" was that Staples would use competitively sensitive information about Essendent's customers to gain an advantage over rival sellers of office products to mid-sized business customers. Alongside this vertical effect, the FTC investigated, but ultimately rejected, other vertical effects, including input foreclosure to rival suppliers of office products. The FTC also ultimately rejected customers' complaints that the horizontal overlap between Staples and Essendent in the purchase of office supplies would result in the merged firm's gaining monopoly power on the "buy side" – monopsony power – in the acquisition of office supplies from distributors or manufacturers. See the statement of the majority, at note 2.

mergers may give rise to concern over emerging vertical relationships or over horizontal effects; and (2.) concerns due to vertical relationships are investigated using approaches and methods discussed under the VMG, while concerns over horizontal overlaps are investigated using approaches and methods identified in the U.S. Horizontal Merger Guidelines (HMG).[4] I read the present text of the draft as explaining only that the Agencies may rely on the types of *evidence* identified in the HMG to investigate the types of competitive *effects* identified in the VMG. With further clarification along the lines discussed above, the VMG would better serve generalist audiences involved with merger enforcement, including businesses, investors and the courts.

II. LIKELIHOOD OF COORDINATION AND RAISING RIVALS COSTS (RRC)

An important insight regarding raising rivals costs strategies is that when a vertically integrated firm attempts to foreclose (un-integrated) rivals using RRC methods, vertically integrated rivals may have an incentive to tacitly coordinate on the strategy by themselves also foreclosing un-integrated rivals.[5] Consider a hypothetical transaction involving a "pure" vertical merger in which the unintegrated, down-

[4] U.S. Department of Justice and the Federal Trade Commission, "Horizontal Merger Guidelines." 2010 (August 19). Online at: https://www.ftc.gov/system/files/documents/public_statements/804291/100819hmg.pdf

[5] Thomas G. Krattenmaker and Steven C. Salop, Anticompetitive Exclusion: Raising Rivals' Costs To Achieve Power over Price, 96 Yale L.J. (1986). "Even if both the firm(s) purchasing exclusionary rights and any established rivals whose costs are not increased by these rights can expand or enter to take up the slack, they may lack the incentive to do so. After the exclusion of the rivals, these firms may be sufficiently few that they can then choose not to compete but, rather, to collude expressly or to coordinate tacitly among themselves to restrain output and raise price. Purchasers gain power over price when exclusionary rights agreements remove restraints on their pricing (and output) decisions. (§IV.B.2.b , pp. 244-245)"

stream merging partner competes with another un-integrated competitor in its stage of a supply chain and with two vertically (backward-)integrated competitors, i.e, the vertically integrated competitors also supply relevant inputs to themselves and their downstream rivals. In this hypothetical, the unintegrated downstream merging partner acquires one of two unintegrated input suppliers. Pre-merger, both vertically integrated input suppliers and both un-integrated input suppliers trade with all (four) downstream customers. Although the number of competitors does not change in either the upstream or downstream stages post-merger, input supply is controlled by *three* vertically integrated firms and an un-integrated supplier post-merger. Depending on purchasing patterns and technology, prices, and margins, an analysis of unilateral effects may indicate that post-merger input foreclosure is unlikely to be profitable to the merged firm, whereas total or partial input foreclosure conditional on post-merger coordination among the vertically-integrated firms may be found to generate substantially higher profits.

Indeed, the Agencies have analyzed the potential that a vertical merger may result in coordinated adoption of RRC strategies and these concerns have not been limited to situations where the merger eliminates a maverick.[6] The courts have found both

Also, Michael H. Riordan and Steven C. Salop, "Evaluating Vertical Mergers: A Post-Chicago Approach." Antitrust Law Journal, Vol. 63, No. 2 (Winter 1995). "... vertical mergers can lead to exclusionary effects by increasing rivals' costs of doing business. This may involve raising their input costs by foreclosing their access to important inputs or foreclosing their access to a sufficient customer base. We refer to these respectively as input foreclosure and customer foreclosure. This exclusionary conduct may involve unilateral and/or the *increased likelihood of coordinated conduct* in the upstream and downstream markets (p. 519, emphasis supplied)."

[6] At §7 of the draft VMG, titled "Coordinated Effects", the text appears to include a discussion of the potential that a merged firm may use RRC strategies to harm a *maverick* firm to improve coordination with other rivals participating in the market. "For example, the merged firm could use its power over a product or service in a related product to harm the ability of a non-merging maverick in the relevant market to compete, thereby increasing the likelihood of coordinated interaction among the merged firm and rivals participating in that market (Draft VMG, §7, p. 8)."

false positives and false negatives in the Agencies' vertical merger enforcement with respect to the Agenices' analysis of the likelihood of coordination over RRC strategies post-merger.[7]

In addition to resorting to maverick theories, the Agencies could assess the likelihood of coordinated effects from vertical mergers based on (1.) the level of industry concentration post-merger, (2.) whether the industry is susceptible to coordination, and (3.) whether the merger is likely to enhance that vulnerability, including whether the merger increases the gains from coordination,[8] For example, the Agencies could extend the economic modeling described in §5.a of the draft VMG to quantify the likely gains from coordination, using sensitivity analysis to address uncertainty as to the duration and number of rivals that engage in coordination. Evidence that the expected gains are sensitive to small changes in assumptions tends to suggest that coordination is unlikely to be enhanced by the merger, while a finding

[7] In the proposed merger of AT&T and TimeWarner, the court rejected the Division's claim that the merged firm would likely foreclose the supply of content to online distributors in coordination with Comcast, so this is a *false positive*. Memorandum Opinion (ECF #146), *United States v. AT&T Inc.*, Case 1:17-cv-02511-RJL, (D.D.C. 6/12/2018): "The Government posits that the challenged merger would also create a likelihood that AT&T would coordinate with Comcast-NBCU to harm virtual MVPDs. ... neither ... expert testimony nor its other evidence is even close to sufficient to support its coordination claim (p. 157)."

In 2018, interior molded door manufacturer Steves and Sons won a jury verdict against Jeld-Wen, Inc., which was vertically integrated into the supply of interior molded doorskins and the downstream product, interior molded doors. Steves and Sons claimed that Jeld-Wen had gained market power through its 2012 merger with CMI, which was cleared by the Division, and that Jeld-Wen then coordinated with rival Masonite to partially foreclose the supply of interior molded doorskins to un-integrated downstream rivals including Steves and Sons. Memorandum Opinion (ECF #1783), *Steves and Sons, Inc. vs. Jeld-Wen Inc.*, Case 3:16-cv-00545-REP (E.D. Va. 10/5/2018). The Division reviewed the transaction in 2012, and retrospectively in 2015 upon a complaint from Steves and Son, but did not find that the merger enhanced the likelihood of coordination, so this is a *false negative*. See also, Steven C. Salop, "Analyzing Vertical Mergers to Avoid False Negatives: Three Recent Case Studies." *Antitrust*, Vol. 33, No. 3, 2019 (Summer); pp. 27 - 36.

[8] US HMG at note 4. On analysis of coordinated effects generally, see §7, pp. 24-27; on the relevance of gains from coordination, see §7.2, p. 26: "The Agencies regard coordinated interaction as more likely, the more the participants stand to gain from successful coordination."

of positive expected gains from coordination under a range of alternate assumptions regarding coordination post-merger is consistent with an inference that the merger enhances the likelihood of coordination.

Both the literature and recent litigation suggest that vertical mergers can enhance the likelihood of coordination to raise rivals costs, as discussed above. It would be helpful for the VMG to identify the thresholds for shares and concentration in the downstream and/or upstream markets above which the Agencies investigate the effect of the merger on the likelihood of coordination, such as occurred subsequent to Jeld-Wen's acquisition of CMI.

III. REVIEW OF CUSTOMER COMPLAINTS AND CUSTOMER TESTIMONY

While customer complaints are seen as potentially informative with respect to potential harms of horizontal mergers,[9] they are considered problematical in the context of vertical mergers.[10] In any event, customer complaints as to a general concern regarding the likely competitive effects of vertical mergers, or of prior vertical mergers, have been dismissed as being insufficient to support an inference regarding the

[9] US HMG at note 4; §2.2.2, p. 5. *Also*, Heyer, Ken, "Predicting the Competitive Effects of Mergers by Listening to Customers." *Antitrust Law Journal*, Vol. 74, No. 1 (2007), pp. 87-127.

[10] "Customer testimony would be ... problematic in a vertical mergers case as the directly affected customer might also be a competitor." Salinger, Michael, 2005, "Is It Live or Is It Memorex? Models of Vertical Mergers and Antitrust Enforcement", Comments before the Association of Competition Economics Seminar on Non-Horizontal Mergers (September). Online at https://www.ftc.gov/sites/default/files/documents/public_statements/it-live-or-it-memorex-models-vertical-mergers-and-antitrust-enforcement/050927isitlive.pdf; downloaded February 11, 2020.

likely competitive effects of a proposed merger.[11] Input-purchaser customers may be most helpful for gathering data needed to conduct analysis of the incentives of the integrated firm to engage in RRC strategies. Customer testimony may also be useful to the Agencies for identifying theories of harm from input foreclosure or customer foreclosure, but those theories must necessarily be tested against the data and other relevant facts of a given merger to assess the likelihood that a proposed merger results in input- or customer-foreclosure.

[11] "The Government points to statements made by defendants in the context of prior regulatory proceedings, and statements contained in internal documents such as slide decks and emails created by various individuals within the defendant companies. Neither category, however, was of any particular probative value." Memorandum Opinion at note 7; p. 79.