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Revising the Vertical Merger Guidelines (FTC Hearings)

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Introduction

• Goals of Presentation
  • Overarching goal is to stimulate deeper discussion and analysis.
  • Provide an overview of the rationale, basic structure of potential revised VMGs.
  • Flag several policy economic, legal and policy issues involved in revising the VMGs.

• Caveat: Given time restrictions, this deck and the presentation are limited
  • See Appendix slides for further discussion of the economic analysis.

• Many of these issues are analyzed in more detail in these academic articles
  • Salop, *Invigorating Vertical Merger Enforcement*, YALE L.J. (May 2018)

• Selected articles by others also are referenced in these academic articles.
Overview of Initial Presentation

• Introduction: Why revise the vertical merger guidelines (VMGs)?

• Economic Analysis
  • Basic economic analysis of vertical merger potential harms and benefits.
  • Why competitive effects of vertical and horizontal merger are not inherently different.

• Policy Analysis
  • Why claimed efficiencies and other arguments do not justify more permissible policy presumptions for vertical mergers.
  • Summary of proposed 3-step competitive effects analysis.

• Appendices summarize some other VMG drafting issues
  • Appendix A: Some further details of economic analysis.
  • Appendix B: Some implications of AT&T/Time Warner opinion.
Key Points

• Enforcement should be focused on oligopoly markets

• Harms and benefits from vertical and horizontal mergers are not inherently different in oligopoly markets
  • Vertical merger form is “vertical” but harms are “horizontal”

• A stronger overarching procompetitive presumption for vertical mergers does not make sense in oligopoly markets
  • Elimination of double marginalization and other efficiencies are neither inevitable nor necessarily merger-specific

• Only cognizable efficiencies (verifiable, merger-specific, procompetitive) should be credited, with the burden on the merging parties

• Revised Vertical Merger Guidelines should reflect these points
Why Revise the Vertical Merger Guidelines

• 1984 VMGs are woefully out of date
  • Do not reflect current economic learning
  • Do not reflect agency enforcement (consent decrees; FCC proceedings)
• 1984 VMGs do not provide useful guidance on current economics or merger policy to the various players
  • Courts analyzing agency complaints
  • Agency staff investigating mergers
  • Businesses considering vertical mergers
  • Outside attorneys counseling
• Professional consensus exists for revision of 1984 VMGs
  • AMC
  • ABA Presidential Transition Reports (2012; 2016)
Common Counter-Arguments Against Revising the VMGs

• **Counterargument #1: Revision fails a cost-benefit analysis**
  - Cost is high because drafting would use up scarce resources
  - Cost is high because the analysis is complex and difficult
  - Benefits are low because analysis is complicated, so devising useful guidance would be impossible
  - Benefits are low because proper analysis is well-known
  - Benefits low because there is so little vertical merger enforcement (50+ consents in 20+ years)
  - Benefits are low because there should not be any vertical merger enforcement

• **Counterargument #2: Revised VMGs will lead to more enforcement by educating and empowering the agencies**
  - This will lead to more false positives *(relative to the reduction in false negatives?)*
Economic Analysis and Policy Implications
Vertical Mergers Defined

- **Horizontal merger**: merging firms sell products or services that are substitutes for one another
  - Two products are *substitutes* if the demand for one product *increases* as the price of the other product rises
  - Diversion ratio is positive
- **Vertical merger**: one merging firm is an actual or potential supplier or customer of the other merging firm
- **Complementary product merger**: merging firms sell products or services that are complements for one another
  - Two products are *complements* if the demand for one product *decreases* as the price of the other product rises
  - Diversion ratio is negative
  - Complementary product mergers raise similar issues and can be analyzed similarly to vertical mergers
- **A particular merger may be both horizontal and vertical**:
  - Substitutes for some consumers and complements for others
  - Vertical in one market and horizontal in another
  - Complementary product firms may be potential competitors into each other’s market
  - One or both merging firms may already be vertically integrated
Basic Economics (Competitive Effects) Issues

Competitive Harms

- Foreclosure
  - Force 2-level entry or eliminate potential competition
  - Input foreclosure
  - Customer foreclosure
  - Strategic misuse of rivals’ confidential information

- Collusion/Coordination (Upstream or Downstream)
  - Foreclosure leading to coordination
  - Disadvantaging disruptive buyer or maverick
  - Collusive information exchange

- Exercise of pre-existing market power
  - Evasion of regulation
  - Facilitation of harmful price discrimination

Enforcement should be focused on oligopoly markets

Competitive Benefits

- Coordination in production, design, innovation from information transfer/exchange
  - Cost reductions
  - Quality improvements
  - Faster/better innovation

- Harmonization of incentives in vertical and complementary mergers
  - Elimination of free riding (including investment)
  - Elimination of double marginalization (“EDM”)

- Creation of a maverick

Only cognizable efficiencies should be credited (i.e., verifiable; merger-specific; procompetitive)

Overall effect on consumers compares likelihood and magnitudes of harms to cognizable efficiency benefits, based on factual analysis
Key Policy Issues

- This presentation focuses primarily on the policy issues that may arise in drafting VMGs
  - Economic theories of harms and benefits appear less controversial
  - Appendix A provides details of economic theories and questions regarding merger-specificity
  - Salop & Culley *JAE* article lists potentially probative evidence to evaluate these various theories

- **Key policy questions**
  - Are vertical mergers so less concerning than horizontal mergers that the legal and policy analysis should differ substantially?
  - Should vertical mergers be treated systematically more permissively than horizontal mergers? If so, how?

- **My conclusions and recommendations**
  - Problematic vertical mergers are “vertical,” but the harms are “horizontal”
  - A stronger overarching procompetitive presumption for vertical mergers does not make sense in oligopoly markets where vertical merger enforcement would be focused (*same as horizontal mergers*)
**Vertical and Horizontal Merger Competitive Issues are Not Inherently Different: Summary**

- Foreclosure harms from vertical mergers are similar and not “less inherent” than unilateral harms from horizontal mergers.
  - In the pre-merger market, the upstream merging firm that supplies a downstream firm is inherently an “indirect competitor” of the future downstream merging firm. That indirect competition is eliminated by merger. This unilateral effect is exactly parallel to the unilateral effect from a horizontal merger.
  - In fact, the vertical GUPPI is similar to the horizontal GUPPI (though reduced by the upstream pass-thru rate and increased with a higher diversion ratio if foreclosure targets multiple downstream rivals).

- Vertical integration (including combining complements) is common. But so is horizontal integration, combining substitutes, as result of economies of scope & scale.
  - Many firms sell multiple substitute products (e.g., Coke and Sprite; premium and value products).
  - Partnerships among competitors and horizontal mergers are common.

- Vertical merger efficiencies are not inevitable. Vertical integration is common. But vertical non-integration also is common.
  - Coca Cola has not merged with McDonalds; Pepsi acquisition of KFC& Pizza Hut failed.
  - Sony Betamax was beaten out by JVC’s VHS open standard.
  - Fox bought but then sold DirecTV and Time Warner and TCI/Liberty separated distribution and content.
  - Alcoa has broken up into separate upstream and downstream firms (Alcoa and Arconic).

- The key issue is not about whether there are efficiencies, but rather whether the efficiencies are merger-specific.
  - Efficiencies often can be achieved without merger: *i.e., vertical integration “by contract.”*
  - The burden to show merger-specific efficiencies should be placed on the merging firms, just like they are for horizontal mergers and other antitrust areas.
Vertical and Horizontal Merger Competitive Concerns are Not Inherently Different: *Unilateral Effects*

- Vertical merger harms involve "horizontal" effects (i.e., reduce horizontal competition)
- Upward pricing pressure (UPP) analysis is similar
  - Horizontal mergers have UPP from the unilateral incentive to raise price to drive incremental sales to the merger partner.
  - Vertical mergers have UPP from the upstream firm (U) having a unilateral incentive to drive incremental sales to its merger partner (D) by raising the price it charges to downstream rivals (R).

\[
\text{Vertical GUPPI}_R = \text{Div Ratio}(R,D) \times \text{Margin (D)} \times \text{Cost Pass-Thru Rate (U)}
\]

*Diversion Ratio rises if more rivals are targeted simultaneously*

Vertically merging firms are "indirect" competitors
- See diagrams on next slides
Pre-merger Indirect Competition Between $U$ and $D$

Firm U “indirectly” competes with Firm D by supplying inputs to Firm R
Merger of $U$ & $D$ plus Foreclosure Reduces Indirect Competition between $U$ and $D$: Forces Involuntary Coordination by $R$
“Indirect Competition” Characteristic: Summary

- By supplying cost-effective inputs to a downstream rival (*call it R*) of another downstream firm (*call it D*) in the pre-merger market, an upstream supplier (*call it U*) “supports competition” by this downstream rival (*R*) with the other downstream firm (*D*).
- **Thus, the input supplier (U) effectively is an “indirect competitor” of the other firm (D).**
- If the supplier (*U*) and other firm (*D*) then merge, and the supplier (*U*) raises price to the rival (*R*), then this “indirect competition” can be reduced or eliminated.
- Raising the costs of the rival (*R*) may essentially coerce it involuntarily to coordinate with the merging downstream firm (*D*).
Vertical and Horizontal Merger Competitive Concerns are Not Inherently Different: Impact on Mavericks

- Horizontal mergers can eliminate a maverick or change its incentives.
- Vertical merger effects on mavericks can be analogous in several ways:
  - If the upstream merging firm \((U)\) is a “maverick” that prevents coordination among upstream input competitors, a merger between downstream firm \((D)\) and upstream firm \((U)\) could eliminate this incentive and lead to a higher likelihood of coordination in the upstream market.
  - If merging downstream firm \((D)\) is a “disruptive buyer” that prevents coordination among upstream input competitors, a merger between this merging downstream firm \((D)\) and one of the upstream firms could eliminate this incentive and lead to a higher likelihood of coordination in the upstream market.
    - Downstream merging firm would be protected from input price increases.
  - The upstream merging firm can be incented by the merger to exclude or raise price to an unintegrated downstream maverick in order to facilitate downstream coordination that will benefit the downstream merging firm.
Vertical and Horizontal Merger Competitive Concerns are Not Inherently Different: Coordination

- Horizontal mergers can facilitate horizontal coordination in various ways.
- Vertical mergers also can lead to horizontal coordination:
  - Merger can facilitate coordination by, for example, raising costs of smaller rivals.
  - Merger can enable reciprocal pricing or licensing coordination by integrated firms.
  - Merger can change incentives of a pre-merger maverick or disruptive firm.
  - Merger can lead to horizontal information exchange.
Potential Efficiencies Do Not Call for a Different Approach than Horizontal Mergers

- Both horizontal and vertical mergers may lead to merger-specific efficiencies
  - Many firms produce multiple substitutes from economies of scope, information sharing, and reputational goodwill benefits.
- Claimed justifications for a differential approach for enforcement in oligopoly markets are invalid
  - Old Chicago-school economic theory presumptions are not economically correct.
  - Econometric evidence does not support a procompetitive presumption for vertical mergers in oligopoly markets.
  - Complaints by downstream competitors do not justify a procompetitive presumption.
  - *Sylvania* and *Leegin* do not mandate or support a procompetitive presumption for vertical mergers in oligopoly markets.
- Recognition and acceptance of these points also can avoid “confirmation bias” by merger analysts and courts.
Old Borkian Claims Do Not Support a Stronger Procompetitive Presumption

- “Foreclosure” is not illusory, and is not simply a neutral rearrangement of supplier-customer relationships.
- Markets do not inevitably or quickly self-correct, especially if the conduct raises the costs of rivals or erects barriers to entry.
- The “single monopoly profit” theory only applies to limited, extreme market structures.
- Elimination of double marginalization (EDM) and other efficiencies are not inevitable and may not be merger-specific.
- See Salop (YLJ) for details.
EDM and Other Efficiencies are Neither Inevitable nor Necessarily Merger-Specific

- Efficiencies are not inevitable. Many firms are not vertically integrated, despite imperfect competition at both levels.
- *Coase’s door swings both ways*: Efficiencies often can be achieved by vertical contracts, without the potential anticompetitive harms from merger.
  - In that vertical restraints are characterized as “just” vertical integration “by contract,” then claimed efficiencies in problematical mergers might be achieved with non-merger contracts that do not raise the same anticompetitive concerns.
- EDM may not be merger-specific
  - EDM might be achieved with non-linear prices or quantity-forcing contracts.
  - Note also that EDM incentives are mitigated by the “opportunity cost” of shifting more profitable sales that upstream merging firm makes to downstream rivals and impact of lowering prices to existing customers. (*See Moresi/Salop; Rogerson*).
- Failure to achieve efficiencies pre-merger does not prove merger-specificity
  - Failure could suggest that they also would not be achieved post-merger.
- A general claim of “bargaining frictions” is *not* sufficient evidence of merger-specificity.
  - Merging parties must provide rigorous explanation, identifying specific pre-merger impediments that are not themselves anticompetitive.
  - They must explain why impediments solved by the merger.
Econometric Evidence Does Not Support a Stronger Procompetitive Presumption

- See econometric studies listed in LaFontaine & Slade; Cooper et al; Salop (YLJ).
  - Estimated competitive effects are mixed.
- In addition, various caveats apply to evaluation of econometric studies:
  - Selection bias towards no effect because antitrust deters the most worrisome mergers.
  - Many studies involve competitive markets where problems are unlikely.
  - Some studies are not capable of distinguishing RRC from EDM; some studies find neither effect.
  - Sample of studies (industries) is not random – limited by data availability.
  - Studies of intrabrand restraints are not good predictors of impact of interbrand effects of vertical mergers in oligopoly markets.
  - Stock market event studies are subject to fundamental criticisms.
  - Some studies have data or econometric issues.
Complaints By Downstream Competitors Do Not Support a Stronger Procompetitive Presumption

- Chicago-school inference that complaints by competitors imply that horizontal merger is procompetitive.
  - If merger will reduce costs, then competitors are harmed and will complain.
  - If merger will facilitate coordination, then competitors benefit and will not complain.
- Inference fails if horizontal or vertical merger will raise rivals’ costs.
  - Now interests of consumers and interests of competitors are aligned.
- A view that firms tilt testimony towards self-interest would lead to equal skepticism of testimony by merging firms.
Sylvania and Leegin Do Not Mandate or Support a Stronger Procompetitive Presumption

• Both cases involve a small manufacturer’s intrabrand vertical restraints.
  • e.g., Territorial restrictions; RPM

• But vertical mergers are more like interbrand restraints, which are more concerning.
  • e.g., Exclusive dealing

• Leegin did not adopt an overarching procompetitive presumption.
  • Leegin adopted the conventional rule of reason, which corresponds to a “relatively neutral” competitive presumption.
Legal Context and Impact on VMG Policy
VMGs in the Shadow of the Law

• **Issue:** Should VMGs simply describe agency analysis, irrespective of merger law?
  - HMGs do not make legal judgments, but they follow merger law.
  - The VMGs (as prosecutorial judgments) also must be consistent with basic merger law.

• **Legal framework choices**
  - *Autolite, Brown Shoe,* and *Freuhauf*;
  - Horizontal merger law (as DOJ recommended in AT&T/TW);
  - Judge Leon’s 3-step legal approach in *AT&T/TW*;
  - Wait to see how DC Circuit sets out the law in *AT&T/TW*.

• **Likely DC Circuit approach in AT&T/Time Warner**
  - Follow the same basic 3-step burden-shifting structure used in *Baker Hughes,* subsequent horizontal merger cases, and Judge Leon in *AT&T/TW*.
  - The question is the plaintiff’s burden in light of Section 7.
  - **My proposal:** Require the same structure and standards as for horizontal mergers.
Application of Basic Merger Law

• In *Baker Hughes*, the DC Circuit set out a 3-step burden-shifting approach for horizontal mergers (with sliding scale extended in *Heinz*):

  • **Step 1**: Agency establishes sufficient evidence to establish a prima facie case of harm (ignoring potential efficiency benefits); if so, …

  • **Step 2**: Burden shifts to merging firms to rebut by showing no harm; or by producing sufficient evidence of cognizable efficiency benefits; if so, …

  • **Step 3**: Burden shifts back to agency to establish overall anticompetitive effects.

• **Standard of proof takes into account the role of “incipiency” in Section 7 standards**:
  • Prediction
  • Probability, not certainty
  • Prominence of “false negatives” (including under-deterrence) concerns
  • *Philadelphia Nat’l Bank*: Application of anticompetitive structural presumption to replace or supplement case-specific evidence in Step 1.
Possible Policy Criticisms of Applying the Same 3-Step Approach as for Horizontal Mergers

“Vertical mergers in oligopoly markets should be presumed to be highly efficient and procompetitive”… So,

“Plaintiff should face more demanding standard of proof.”
“Plaintiff should bear burden to disprove efficiencies.”
“Efficiencies should be conclusively presumed to be merger-specific.”

But …

• These attempts to distinguish vertical and horizontal mergers in oligopoly market are not supported by rigorous analysis (as discussed earlier).

“Unlike horizontal mergers, there is no PNB structural presumption” … So,

“Plaintiff should bear all burdens”

But…

• The 3-step decision process is used throughout antitrust without a structural presumption, because there are other ways to establish a prima facie case….

• Presumptions can be based on factors other than the increase in market concentration.
DOJ PCOL in AT&T/TW Proposes The Following Legal Standards

• Section 7 of the Clayton Act proscribes mergers that may substantially lessen competition.
• To “arrest restraints of trade in their incipiency,” Section 7 proscribes any merger creating a “reasonable probability” of harm.
  • Harm from the merger need not happen immediately for Section 7 to apply.
  • A Section 7 plaintiff does not need to quantify the potential harm.
  • Section 7 does not contain an exemption for “minor” price increases.
  • The same Section 7 standards apply to horizontal and vertical mergers.
• Courts analyze Section 7 claims through a burden-shifting framework.
• A vertical merger may substantially lessen competition by giving the merged firm the incentive and ability to disadvantage its rivals.
  • When a vertical merger enables the merged firm to raise its rivals’ costs, competition is lessened substantially.
  • When a vertical merger enables the merged firm to encumber its rivals’ access to a unique resource, competition is lessened substantially.
  • When a vertical merger enables the merged firm to impede innovation, either unilaterally or through coordination, competition is lessened substantially.
• Defendants may rebut a prima facie case only by showing that competitive harm is not “reasonably probable.”
  • Entry must be timely, likely, and sufficient to prevent competitive harm.
  • Claimed efficiencies (which arguably cannot ever save a merger) must withstand “rigorous analysis.”
    • Defendants bear the burden of their efficiencies defense.
    • Efficiencies must be reasonably verifiable, merger-specific, and likely to benefit consumers in the affected markets, and must offset the harms of the merger.
    • The Court cannot credit Defendants’ purported efficiencies.
  • A unilateral behavioral promise, such as an arbitration offer, cannot rebut a prima facie case.
Further Analysis of 3-Step Decision Process
Step 1: Establishing Prima Facie Case

- **Step 1 prima facie case satisfied with evidence (including applicable presumptions):**
  - Evidence of oligopoly markets with entry barriers.
  - Economic and documentary evidence of likely consumer harm.

- **“Reasonable probability” as my proposed evidentiary standard:**
  - “Incipience” concern suggests a less demanding standard.
  - Step 1 is implemented under the interim assumption of no efficiencies, which reduces the burden.
  - This also suggests that (precise, if any) quantification should not be required.
  - Query: Since zero efficiencies are assumed, is it sufficient to show harm to downstream competitors in Step 1?

- **VMGs might formulate a safe harbor (as do HMGs):**
  - E.g., Both upstream and downstream markets are unconcentrated.
  - *Note:* This test should require both standard and modified HHIs (not including the merging firms) also be unconcentrated.

- **VMGs might formulate types of anticompetitive presumptions, such as the following…**
  - One merging firm is dominant in its market and other merging firm is a unique (or critical?) entry sponsor; or
  - Upstream merging firm has (significant) market power in a concentrated input market and supplies a critical input to the competitors of the downstream merging firm; or
  - Downstream market is highly concentrated and upstream merging firm is a maverick that supplies a critical input; or
  - Upstream market is highly concentrated and downstream merging firm is a disruptive buyer or accesses sensitive competitive information from upstream firms; or
  - Vertical merger structure would permit evasion of price regulation.
Step 2A: Structural Rebuttal

• Potential rebuttal based on various structural and other factors (even aside from efficiencies) that would prevent competitive harm
  • Follow Baker-Hughes, Heinz and HMGs

• Factors can include the following …
  • Substantial input substitution
  • Easy entry or repositioning
  • Sufficient competition from non-targeted rivals
  • Countervailing buyer power
  • Failing firm
  • Relevant natural experiment evidence
Step 2B: Efficiency Rebuttal

- **Burden on defendant to produce reasonable evidence of “cognizable” efficiencies**
  - Verifiable; Merger-specific; not flowing from anticompetitive conduct or effects
- **Burden to prove merger-specificity typically placed on defendants**
  - Firms have superior access to information on claimed efficiencies
- **Merger-specificity requirement also is appropriate for vertical mergers**
  - Efficiencies often can be achieved by contract, without the potential anticompetitive harms from merger (Coase)
  - Elimination of double marginalization (EDM) might be achieved with non-linear price or quantity-forcing contracts
  - Failure to achieve efficiencies pre-merger does not prove merger-specificity, but instead could suggest low benefits or inefficient management
  - A general claim of “bargaining frictions” is not sufficient evidence
- **Verifiability requirement is also appropriate**
  - Efficiency may be difficult to achieve in light of differential knowledge
  - As noted earlier, EDM incentives are mitigated by “opportunity costs”
Step 3: Ultimate Burden of Persuasion

- Plaintiff must show “reasonable probability” of anticompetitive effects
  - Section 7 (“may substantially lessen competition”)
  - “Reasonable probability” evidentiary standard flows from “incipiency” concerns in statute
  - “Overall” anticompetitive impact on consumers
  - “Overall” means harms sufficient to outweigh competitive benefits to consumers from merger-specific efficiencies
- But this still raises two possibly contentious issues
  - What if there is harm to customers of downstream rivals (from RRC) but benefits to customers of merging firms (from efficiencies)?
  - What if there is harm to direct customers of the upstream merging firm, who are competitors of the downstream merging firm. Must harm to the downstream rivals also be established?
Is Injury to a Subset of Customers of Downstream Firms Sufficient for Liability?

- Suppose harm only to the customers of foreclosed downstream rivals
- Suppose in a differentiated product market it is found that …
  - **RRC**: Input foreclosure leads **downstream rivals** to raise their prices
  - **Efficiencies**: Merger-specific EDM leads **merging firm** to reduce its downstream price
  - *Example: Coke & Pepsi bottler mergers has these estimated effects* (Luco & Marshal)
- **Finding liability here is consistent with HMGs analysis of harm in targeted buyer markets**
  - In horizontal mergers, balancing benefits in one market to offset anticompetitive effects in another market is not permitted (i.e., *PNB*)
  - Aggregating effects involve difficult interpersonal comparisons because no compensation
- **Issue for Discussion**: Should VMGs contain some limited balancing under prosecutorial discretion, as in HMGs “inextricably linked” footnote
Is Injury to Downstream Rivals Sufficient for Liability?

- **Must the plaintiff show harm to customers of the downstream firms?**
  - Or, is it sufficient to show harm to the direct purchasers of the upstream firm, who are also the (downstream) competitors of the merged firm?
  - In *AT&T/TW*, DOJ focused on injury to *customers of downstream firms*, but proposed that harm to the *downstream competitors* is sufficient for liability

- **Conflicting overarching antitrust views**
  - Downstream firms are the “direct purchasers” of the upstream merging firm; and “direct purchasers” are the usual antitrust focus
  - But, it is said that merger law protects “competition, not competitors”

- **Issues for discussion**
  - Suppose the merger likely would *facilitate coordination among upstream firms*. Would it be sufficient in this situation merely to show harm to the *unintegrated* downstream firms?
  - Suppose foreclosure harms the unintegrated downstream competitors and there are *zero merger-specific efficiencies*. Then harm to the competitors might lead to a *presumption of harm* to the customers of the downstream firms. *(But not a certainty: what if consumers would switch to non-foreclosed rivals or other products?)*
  - What if there are merger-specific efficiencies? Should effects on downstream consumers be *paramount*? Or, should harm to downstream rivals be *balanced* against downstream consumer benefits?
Remedy Formulation

Issue for Discussion: Should VMGs discuss remedies?

If so, …

- Structural remedies are preferred
- Behavioral remedies can be problematic
  - Difficult to monitor and enforce
  - Often fail to foresee future anticompetitive concerns or conduct
  - But, better than clearing anticompetitive mergers
- Consent decrees can be strengthened
  - Include look-backs and potential for revisions if decree fails to preserve competition
- Or, “just say no.”
Conclusions

• **Agency Process**
  • New VMGs are needed.
  • New VMGs are doable.
  • The DOJ’s AT&T/TW case began a useful process.
  • The DOJ and FTC do not need to wait for AT&T/TW opinion to begin work.

• **Analytic Framework**
  • The *Baker Hughes/Heinz* 3-step analysis can be adapted and applied to vertical mergers.
  • The economic categories and issues can be described and analyzed, and probative evidence can identified.

• **Recommended Policy Approach**
  • Vertical mergers in oligopoly markets do not deserve a differential presumption or inherently more permissive standards than horizontal mergers.
  • Both deserve rigorous, yet balanced, agency analysis.
  • Analysis and interpretation should avoid “confirmation bias.”
Appendix A:
Basic and Illustrative
Economic Analysis
Forcing 2-Level Entry

Hypo Merger (circa 2000) : Microsoft (OS)--Google (Search)

Microsoft (OS)

Potential OS Entrant (Google - Android?)

Google (Search)

Potential Search Entrant (Microsoft - Bing?)

Consumers

Refuse to enter or sponsor entry at other level

Maintain monopoly prices at both levels
Input Foreclosure

- Probably the most common claim
- Several ways to “raise rivals’ costs”
  - Refusing to sell input (“withholding;” “total foreclosure”)
  - Unilaterally raising price
  - Increased bargaining leverage, leading to higher negotiated price
  - Variant: Reducing/degrading quality; withholding critical information
- Potential harms at 2 levels
  - Harm to “direct customers” (i.e., downstream rivals)
  - Harm to “consumers” (i.e., customers of downstream firms)
Input Foreclosure: Basic Economic Logic

- Upstream Merging Firm
- Non-Merging Upstream Substitutes
- Potential Entrants
- Non-Foreclosed Rivals (including substitute products)
- Foreclosed Rivals
- Downstream Merging Firm
- Consumers

- Input Price Increase
- Resulting Diversion Of Sales
- Enabled Firm
  Output & Price Increase; market output falls
- Induced Price Increase & Output Decrease

Market output falls due to foreclosed rivals and induced price increase. Resulting diversion of sales from foreclosed rivals to downstream merging firm.
Input Foreclosure:
Basic Competitive Harm Analysis

- **Upstream (Input) Market: Raising Rivals’ Costs**
  - Will firm have power/incentive to raise input price or refuse to sell to targeted rival(s)?
  - Do rivals have cost-effective substitutes (including backward integration or entry)?
    - If input is distribution, can targeted firm engage in cost-effective “direct” distribution?
  - Will substitute input providers have power/incentive to raise prices, unilaterally or thru coordination?
    - *Note: This “multi-lateral” competitive response is typically overlooked in unilateral analyses of input foreclosure*
  - Will rivals’ costs rise materially?

- **Downstream (Output) Market: Power Over Price**
  - Will merging firm have power/incentive to raise prices to consumers, either unilaterally or thru coordination?
  - Is a targeted rival a downstream maverick or disruptive buyer?
  - Do consumers have sufficient cost-effective substitutes – other products or non-targeted rivals? Will they compete or coordinate?
  - Are there other vertically integrated competitors? Will they compete or coordinate?

*Note: Distribution services (distributors) are an input.*
Reciprocal Coordination Equilibrium
Multiple Vertical Mergers with Reciprocal High Prices and MFNs

Consumers

Reciprocal high input prices lead to high output prices
MFNs deter cheating

NBCU

Comcast

Time Warner (Turner/HBO)

Disney (ESPN, ABC)

DirectV; ATT UVerse

Charter or Cox

Consumers

Raise wholesale prices to entrants to increase BTE
Customer Foreclosure

*Example: Hospital/Anesthesia Group Merger*

- East Jefferson Hospital
- Other potential clients of Dr. Hyde
- Roux and Assoc
- Dr. Hyde
- Outpatient Surgical Clinics

EJH denies Privileges

Roux raises prices and increases market share

Dr. H falls below MVS and exits
Customer Foreclosure: Competitive Harm Analysis

• **Reducing Rivals’ Revenues (Customer Market)**
  • Will targeted rival(s) lose significant revenues from loss of merging (downstream) firm as a customer?
  • What fraction of rivals’ sales are accounted for by merging firm? (foreclosure rate)
  • Do targeted rival(s) have ability/incentives to replace lost sales?
  • Are there sufficient other customers?

• **Power Over Price (Input Market)**
  • Will merging input supplier gain the power/incentive to raise or maintain supra-competitive prices?
  • Will targeted rival(s) fall below MVS and exit?
  • Will targeted rival(s) have higher marginal costs?
  • Will targeted rival(s) be marginalized into niche position by inability to grow? Will they reduce investment?

• Will successful customer foreclosure lead to or reinforce input foreclosure?
Input *plus* Customer Foreclosure

**Example: Hospital/Anesthesia Group Merger**

- **Roux and Assoc**
- **East Jefferson Hospital**
- **Dr. Hyde**
- **Outpatient Clinics**
- **Jekyll and Assoc**
- **West Jefferson Hospital**

- EJH denies privileges; Hyde exits
- Jekyll raises prices in response to Hyde exit

Rival hospitals and clinics have higher costs, allowing EJH to raise prices and increase market share.
Examples of Other Coordination Theories

- **Collusive Information Exchange**
  - In 1990s, if a drug company (say, Lilly) acquires a pharmacy benefit manager, PCS, it might be able use PCS information about rival pharma prices to coordinate at manufacturer level by deterring cheating.

- **Eliminating/Disadvantaging a Disruptive Buyer**
  - In 2010, if Amazon was a disruptive buyer of books and thereby preventing publisher coordination, its incentives might change if it acquired a large publisher.

- **Eliminating/Disadvantaging an Upstream Maverick**
  - In 2010, if (say) Prentice Hall were a maverick in selling hardcover books to brick-and-mortar stores and thereby preventing publisher coordination, its incentives might change if it were acquired by Amazon.

- **Eliminating/Disadvantaging a Downstream Maverick**
  - Suppose that a downstream soft drink company (e.g., Dr. Pepper/7UP) is preventing downstream coordination by Coke and Pepsi. A vertical merger by which Coke and Pepsi acquires Bottlers can lead the Bottlers to raise price to the maverick to facilitate downstream coordination.
Evaluating Merger-Specific Efficiencies: Some Probative Questions

- Did the merging parties attempt to achieve efficiencies by contract?
  - If there were no attempts, why no attempts?
  - If there were attempts, why did the negotiations fail?
  - What specific contracting impediments existed?
  - How will the merger eliminate these impediments
  - Could the efficiencies have been at least partially achieved by contract?

- Will the post-merger firm face any impediments to achieving the efficiencies?

- Will the post-merger firm have opportunity costs that would lead them to avoid passing through the benefits to consumers?

- Is achieving these efficiencies inextricably linked to denying the efficiency benefits to rivals?

- Will the merged firm have the incentive to deny the efficiency benefits to rivals?

- Do other unintegrated firms in this or similar industries achieve some or all of the claimed efficiencies by contract?

- Do other integrated firms achieve the claimed efficiencies?

- How large are the efficiency benefits?
Appendix B: AT&T/Time Warner Suggested Drafting Issues
AT&T Case Indicates Some Bargaining Leverage Theory Issues to Explain in VMG

- District court opinion in AT&T/Time Warner merger was confused about important several economic issues:
  - Will separate divisions of integrated firms attempt to maximize total corporate profits?
  - Is the Nash bargaining model premised on frequent or permanent blackouts?
  - In exclusion cases, does the self-interest of foreclosed competitors inherently conflict with consumer interests?
Joint Profit Maximization

• Judge Leon was skeptical that Time Warner would take benefits to AT&T into account in bargaining with AT&T’s competitors, leading him to reject applicability of Nash bargaining model.

• That skepticism is economic and legal error:
  • Contrary to *Copperweld*, which conclusively presumes that divisions of integrated firm act to maximize joint profits.
  • Rejecting this presumption would permit Coke and Pepsi to justify merger on the grounds that each division would be instructed to maximize division profits, not overall corporate profits.
  • Illogical in that taking AT&T interests into account actually will lead to Time Warner obtaining higher negotiated prices and higher profits, not lower (*i.e.*, *unlike total foreclosure where there is profit-sacrifice*).
  • Note: EDM also is based on joint profit-maximization, so illogical to assume EDM while rejecting Nash bargaining model.
Nash Bargaining Equilibrium and Permanent Blackouts

• Judge Leon was skeptical of the Nash Bargaining model because …
  • Blackouts were rare.
  • Permanent blackouts would be “catastrophic” for the video content firm (e.g., TW).
• But, blackouts are not inherent in Nash model.
• Assumption is that agreements will be reached before any blackout occurs precisely because blackouts are costly, or even catastrophic.
Competitor Testimony

• Judge Leon was skeptical of testimony of AT&T's distribution competitors about Time Warner’s increased bargaining leverage from the merger.
• This skepticism corresponds to the view that in horizontal mergers, competitor complaints suggest that merger must be procompetitive.
• That inference fails in vertical mergers where competitors are foreclosed:
  • The competitors are also customers.
  • If their costs are raised, that fact leads to a likelihood that prices will be raised to the customers of the downstream firms, the relevant “consumers” in such cases.
  • This analysis suggests that the competitor/customers testimony is less likely to conflict with consumer interests.
• Judge Leon also did not apply such skepticism to the testimony of AT&T executives, who would gain from an anticompetitive merger.
  • Nor was he so skeptical of testimony by Time Warner top executives, who would achieve a windfall from consummation of the merger.