Memorandum

FTC and DOJ Announce New Draft Vertical Merger Guidelines

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For the first time in nearly four decades, the Federal Trade Commission and the Department of Justice's Antitrust Division, the federal agencies tasked with enforcing United States antitrust laws, have issued updated draft guidelines for evaluating vertical mergers—i.e., mergers of companies operating at different stages of the supply chain.

These new draft guidelines come at a time of heightened debate over vertical mergers and in the wake of the government's unsuccessful challenge of the Time Warner/AT&T merger. The draft guidelines seek to provide insight and greater transparency into how the agencies approach vertical merger analysis and enforcement. Further, although they evidence increased interest in vertical mergers, the draft guidelines largely reflect how the agencies have been reviewing vertical mergers in recent years.

The draft guidelines have been released to the public and are open to comment for 30 days. As discussed further below, two FTC Commissioners issued statements criticizing the guidelines as drafted to be insufficient.

The draft guidelines provide an overview of the methodology that the agencies will follow and identify circumstances in which vertical mergers may result in anticompetitive harm.

Anticompetitive Effects

In evaluating these effects, the agencies will consider a wide variety of evidence, including market share, contractual relationships in the industry, the observed effects of similar mergers, and whether a merging party currently serves as a market disruptor. The draft guidelines identify the following ways in which a vertical merger might harm competition:

- *Unilateral Effects*: The draft guidelines recognize that vertical mergers may cause anticompetitive unilateral effects, such as raising a rival's costs or providing access to a competitor's sensitive information.
  - Raising rival's costs refers to situations where the merged, vertically integrated firm can profitably foreclose rivals in a relevant market by charging more for (or refusing to sell) a vertically-connected product. For example, firm A might sell input materials to firms B and C. But after a vertical merger

between A and B, the merged firm might refuse to sell materials to C, raising C's costs and diverting sales from C to the merged firm.

- A merged firm might also gain access to a rival's sensitive business information, which the draft guidelines explain might cause rivals to "see less competitive value in taking procompetitive actions." For example, a rival might choose to buy inputs from a more expensive or lower quality supplier in order to avoid giving the merged firm the rival's sensitive commercial information.

- *Coordinated Effects*: The draft guidelines also warn that a vertical merger may encourage or facilitate anticompetitive coordinated action. The integrated firm may use power in a relevant market to harm a maverick firm's ability to disrupt established rivals. Alternatively, integrated firms may gain access to information that will allow them to more easily coordinate with rivals. The risk of collusion may be undermined by a realignment of incentives, such as the elimination of double marginalization, discussed below.

Procompetitive Effects and Elimination of Double Marginalization

The draft guidelines recognize certain ways that vertical mergers can help consumers. Accordingly, the draft guidelines identify circumstances where the agencies are unlikely to challenge a vertical merger:

- *Elimination of Double Marginalization*: As stated in the draft guidelines, agencies will not challenge mergers where the net effect of eliminating double marginalization is large enough that the merger is unlikely to be anticompetitive. Double marginalization occurs when the upstream and downstream firms with market power set prices higher than a single integrated firm with market power would. Merging these firms aligns incentives in a way that can increase output and decrease prices, benefiting both the combined firm and consumers. Regulators will consider the net effects by examining the compatibility of technology between firms, existing incentives to reduce double marginalization, and predicted pricing incentives.

- *Efficiencies*: Mergers can help create beneficial efficiencies for consumers. Efficiencies may include combining complementary economic functions, reducing contracting costs, and streamlining production, inventory management and distribution. Additionally, vertically integrated firms may create new valuable products that unintegrated ones cannot. The agencies will evaluate vertical merger efficiencies using the same approach as the Horizontal Merger Guidelines, and will not challenge a vertical merger where the scale of efficiencies suggests that the merger is unlikely to be anticompetitive.

Safe Harbor and the Absence of Any Presumptions

Notably, the draft guidelines advise that the agencies are unlikely to challenge mergers where the parties have less than 20% market share in both the relevant and related product markets. However, unlike the Horizontal Merger Guidelines, the draft guidelines do not establish any presumptions for anticompetitive harm.

Comments From Agency Officials

The FTC's two Democratic commissioners, Rohit Chopra and Kelly Slaughter, separately abstained from the vote on the draft guidelines and issued statements, advocating for even more government scrutiny of vertical integration. Commissioner Slaughter took issue with the safe harbor provision, noting that "creating a market-share based threshold for enforcement may be an imperfect proxy for assessing whether a vertical merger poses competitive concerns." Commissioner Chopra argued that the draft guidelines do not reflect lessons learned from decades of enforcement actions and "perpetuate an overdependence on theoretical models."

FTC Commissioner and Republican appointee Christine Wilson issued a concurring statement acknowledging that open questions remain and inviting feedback on a number of issues. In particular, she asked how the guidelines should treat the elimination of double marginalization, noting that economic literature "recognizes both its significant benefits and the many reasons that these benefits may not be achieved." Commissioner Wilson also raised the question of whether a safe harbor provision was appropriate altogether, and if so, whether the 20 percent threshold in the draft guidelines was correct. Finally, her statement asked how the guidelines should define relevant and related markets, and what size of anticompetitive effects should be considered *de minimis*.

Takeaways

The issuance of the guidelines, which are still subject to comment and further revision, provide insight into how the agencies plan to evaluate and enforce vertical mergers. While they reflect the agencies' heightened interest in vertical mergers, it is uncertain whether they will result in more enforcement actions. Nevertheless, the draft guidelines are an important step in assisting the business community and counsel contemplating and considering potential transactions.

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