# Non-Horizontal Merger Guidelines

*(Originally issued as part of "U.S. Department of Justice Merger Guidelines, June 14, 1984." For horizontal mergers see the "U.S. Department of Justice and the Federal Trade Commission Horizontal Merger Guidelines" issued April 2, 1992 and revised April 8, 1997.)*

## 4. HORIZONTAL EFFECT FROM NON-HORIZONTAL MERGERS

4.0 By definition, non-horizontal mergers involve firms that do not operate in the same market. It necessarily follows that such mergers produce no immediate change in the level of concentration in any relevant market as defined in Section 2 of these Guidelines. Although non-horizontal mergers are less likely than horizontal mergers to create competitive problems, they are not invariably innocuous. This section describes the principal theories under which the Department is likely to challenge non-horizontal mergers.

### 4.1 Elimination of Specific Potential Entrants
### 4.11 The Theory of Potential Competition

In some circumstances, the non-horizontal merger[25] of a firm already in a market (the "acquired firm") with a potential entrant to that market (the "acquiring firm")[26] may adversely affect competition in the market. If the merger effectively removes the acquiring firm from the edge of the market, it could have either of the following effects.

#### 4.111 Harm to "Perceived Potential Competition"

By eliminating a significant present competitive threat that constrains the behavior of the firms already in the market, the merger could result in an immediate deterioration in market performance. The economic theory of limit pricing suggests that monopolists and groups of colluding firms may find it profitable to restrain their pricing in order to deter new entry that is likely to push prices even lower by adding capacity to the market. If the acquiring firm had unique advantages in entering the market, the firms

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[25] Under traditional usage, such a merger could be characterized as either "vertical" or "conglomerate," but the label adds nothing to the analysis.

[26] The terms "acquired and "acquiring" refer to the relationship of the firms to the market of interest, not to the way the particular transaction is formally structured.

in the market might be able to set a new and higher price after the threat of entry by the acquiring firm was eliminated by the merger.

#### 4.112 Harm to "Actual Potential Competition"

By eliminating the possibility of entry by the acquiring firm in a more procompetitive manner, the merger could result in a lost opportunity for improvement in market performance resulting form the addition of a significant competitor. The more procompetitive alternatives include both new entry and entry through a "toehold" acquisition of a present small competitor.

### 4.12 Relation Between Perceived and Actual Potential Competition

If it were always profit-maximizing for incumbent firms to set price in such a way that all entry was deterred and if information and coordination were sufficient to implement this strategy, harm to perceived potential competition would be the only competitive problem to address. In practice, however, actual potential competition has independent importance. Firms already in the market may not find it optimal to set price low enough to deter all entry; moreover, those firms may misjudge the entry advantages of a particular firm and, therefore, the price necessary to deter its entry.[27]

### 4.13 Enforcement Standards

Because of the close relationship between perceived potential competition and actual potential competition, the Department will evaluate mergers that raise either type of potential competition concern under a single structural analysis analogous to that applied to horizontal mergers. The Department first will consider a set of objective factors designed to identify cases in which harmful effects are plausible. In such cases, the Department then will conduct a more focused inquiry to determine whether the likelihood and magnitude of the possible harm justify a challenge to the merger. In this context, the Department will consider any specific evidence presented by the merging parties to show that the inferences of competitive harm drawn from the objective factors are unreliable.

The factors that the Department will consider are as follows.

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[27]When collusion is only tacit, the problem of arriving at and enforcing the correct limit price is likely to be particularly difficult.

### 4.131 Market Concentration

Barriers to entry are unlikely to affect market performance if the structure of the market is otherwise not conducive to monopolization of collusion. Adverse competitive effects are likely only if overall concentration, or the largest firm's market share, is high. The Department is unlikely to challenge a potential competition merger unless overall concentration of the acquired firm's market is above 1800 HHI (a somewhat lower concentration will suffice if one or more of the factors discussed in Section 3.4 indicate that effective collusion in the market is particularly likely). Other things being equal, the Department is increasingly likely to challenge a merger as this threshold is exceeded.

### 4.132 Conditions of Entry Generally

If entry to the market is generally easy, the fact that entry is marginally easier for one or more firms is unlikely to affect the behavior of the firms in the market. The Department is unlikely to challenge a potential competition merger when new entry into the acquiring firm's market can be accomplished by firms without any specific entry advantages under the conditions stated in Section 3.3. Other things being equal, the Department is increasingly likely to challenge a merger as the difficulty of entry increase above that threshold.

### 4.133 The Acquiring Firm's Entry Advantage

If more than a few firms have the same or a comparable advantage in entering the acquired firm's market, the elimination of one firm is unlikely to have any adverse competitive effect. The other similarly situated firm or firms would continue to exert a present restraining influence, or, if entry would be profitable, would recognize the opportunity and enter. The Department is unlikely to challenge a potential competition merger if the entry advantage ascribed to the acquiring firm (or another advantage of comparable importance) is also possessed by three or more other firms. Other things being equal, the Department is increasingly likely to challenge a merger as the number of other similarily situated firms decreases below three and as the extent of the entry advantage over non-advantaged firms increases.

If the evidence of likely actual entry by the acquiring firm is particularly strong,[28] however, the Department may challenge a potential competition merger, notwithstanding the presence of three of more firms that are objectively similarly situated. In such cases, the Department will determine

[28]For example, the firm already may have moved beyond the stage of consideration and have made significant investments demonstrating an actual decision to enter.

the likely scale of entry, using either the firm's own documents or the minimum efficient scale in the industry. The Department will then evaluate the merger much as it would a horizontal merger between a firm the size of the likely scale of entry and the acquired firm.

#### 4.134 The Market Share of the Acquired Firm

Entry through the acquisition of a relatively small firm in the market may have a competitive effect comparable to new entry. Small firms frequently play peripheral roles in collusive interactions, and the particular advantages of the acquiring firm may convert a fringe firm into a significant factor in the market.[29] The Department is unlikely to challenge a potential competition merger when the acquired firm has a market share of five percent or less. Other things being equal, the Department is increasingly likely to challenge a merger as the market share of the acquired firm increases above the threshold. The Department is likely to challenge any merger satisfying the other conditions in which the acquired firm has a market share of 20 percent of more.

#### 4.135 Efficiences

As in the case of horizontal mergers, the Department will consider expected efficiencies in determining whether to challenge a potential competition merger. See Section 3.5 (Efficiencies).

## 4.2 Competitive Problems from Vertical Mergers

### 4.21 Barriers to Entry from Vertical Mergers

In certain circumstances, the vertical integration resulting from vertical mergers could create competitively objectionable barriers to entry. Stated generally, three conditions are necessary (but not sufficient) for this problem to exist. First, the degree of vertical integration between the two markets must be so extensive that entrants to one market (the "primary market") also would have to enter the other market (the "secondary market")[30] simultaneously. Second, the requirement of entry at the secondary level must make entry at the primary level significantly more difficult

[29]Although a similar effect is possible with the acquisition of larger firms, there is an increased danger that the acquiring firm will choose to acquiesce in monopolization or collusion because of the enhanced profits that would result from its own disappearance from the edge of the market.

[30]This competitive problem could result from either upstream or downstream integration, and could affect competition in either the upstream market or the downstream market. In the text, the term "primary market" refers to the market in which the competitive concerns are being considered, and the term "secondary market" refers to the adjacent market.

and less likely to occur. Finally, the structure and other characteristics of the primary market must be otherwise so conducive to noncompetitive performance that the increased difficulty of entry is likely to affect its performance. The following standards state the criteria by which the Department will determine whether these conditions are satisfied.

#### 4.211 Need for Two-Level Entry

If there is sufficient unintegrated capacity[31] in the secondary market, new entrants to the primary market would not have to enter both markets simultaneously. The Department is unlikely to challenge a merger on this ground where post-merger sales (or purchases) by unintegrated firms in the secondary market would be sufficient to service two minimum-efficient-scale plants in the primary market. When the other conditions are satisfied, the Department is increasingly likely to challenge a merger as the unintegrated capacity declines below this level.

#### 4.212 Increased Difficulty of Simultaneous Entry of Both Markets

The relevant question is whether the need for simultaneous entry to the secondary market gives rise to a substantial incremental difficulty as compared to entry into the primary market alone. If entry at the secondary level is easy in absolute terms, the requirement of simultaneous entry to that market is unlikely adversely to affect entry to the primary market. Whatever the difficulties of entry into the primary market may be, the Department is unlikely to challenge a merger on this ground if new entry into the secondary market can be accomplished under the conditions stated in Section 3.3.[32] When entry is not possible under those conditions, the Department is increasingly concerned about vertical mergers as the difficulty of entering the secondary market increases. The Department, however, will invoke this theory only where the need for secondary market entry significantly increases the costs (which may take the form of risks) of primary market entry.

More capital is necessary to enter two markets than to enter one. Stand-

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[31]Ownership integration does not necessarily mandate two-level entry by new entrants to the primary market. Such entry is most likely to be necessary where the primary and secondary markets are completely integrated by ownership and each firm in the primary market uses all of the capacity of its associated firm in the secondary market. In many cases of ownership integration, however, the functional fit between vertically integrated firms is not perfect, and an outside market exists for the sales (purchases) of the firms in the secondary market. If that market is sufficiently large and diverse, new entrants to the primary market may be able to participate without simultaneous entry to the secondary market. In considering the adequacy of this alternative, the Department will consider the likelihood of predatory price or supply “squeezes” by the integrated firms against their unintegrated rivals.

[32]Entry into the secondary market may be greatly facilitated in that an assured supplier (customer) is provided by the primary market entry.

ing alone, however, this additional capital requirement does not constitute a barrier to entry to the primary market. If the necessary finds were available at a cost commensurate with the level of risk in the secondary market, there would be no adverse effect. In some cases, however, lenders may doubt that would-be entrants to the primary market have the necessary skills and knowledge to succeed in the secondary market and, therefore, in the primary market. In order to compensate for this risk of failure, lenders might charge a higher rate for the necessary capital. This problem becomes increasingly significant as a higher percentage of the capital assets in the secondary market are long-lived and specialized to that market and, therefore, difficult to recover in the event of failure. In evaluating the likelihood of increased barriers to entry resulting from increased cost of capital, therefore, the Department will consider both the degree of similarity in the essential skills in the primary and secondary markets and the economic life and degree of specialization of the capital assets in the secondary market.

Economies of sale in the secondary market may constitute an additional barrier to entry to the primary market in some situations requiring two-level entry. The problem could arise if the capacities of minimum-efficient-scale plants in the primary and secondary markets differ significantly. For example, if the capacity of a minimum-efficient-scale plant in the secondary market were significantly greater than the needs of a minimum-efficient-scale plant in the primary market, entrants would have to choose between inefficient operation at the secondary level (because of operating an efficient plant at an inefficient output or because of operating an inefficiently small plant) or a larger than necessary scale at the primary level. Either of these effects could cause a significant increase in the operating costs of the entering firm.[33]

### 4.213 Structure and Performance of the Primary Market

Barriers to entry are unlikely to affect performance if the structure of the primary market is otherwise not conducive to monopolization or collusion.[34] The Department is unlikely to challenge a merger on this ground unless overall concentration of the primary market is above 1800 HHI (a somewhat lower concentration will suffice if one or more of the factors discussed in Section 3.4 indicate that effective collusion is particularly likely). Above that threshold, the Department is increasingly likely to challenge a merger that meets the other criteria set forth above as the concentration increases.

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[33]It is important to note, however, that this problem would not exist if a significant outside market exists at the secondary level. In that case, entrants could enter with the appropriately scaled plants at both levels, and sell or buy in the market as necessary.

[34]For example, a market with 100 firms of equal size would perform competitively despite a significant increase in entry barriers.

### 4.22 Facilitating Collusion Through Vertical Mergers

#### 4.221 Vertical Integration to the Retail Level

A high level of vertical integration by upstream firms into the associated retail market may facilitate collusion in the upstream market by making it easier to monitor price. Retail prices are generally more visible than prices in upstream markets, and vertical mergers may increase the level of vertical integration to the point at which the monitoring effect becomes significant. Adverse competitive consequences are unlikely unless the upstream market is generally conducive to collusion and a large percentage of the products produced there are sold through vertically integrated retail outlets.

The Department is unlikely to challenge a merger on this ground unless 1) overall concentration of the upstream market is above 1800 HHI (a somewhat lower concentration will suffice if one or more of the factors discussed in Section 3.4 indicate that effective collusion is particularly likely), and 2) a large percentage of the upstream product would be sold through vertically-integrated retail outlets after the merger. Where the stated thresholds are met or exceeded, the Department's decision whether to challenge a merger on this ground will depend upon an individual evaluation of its likely competitive effect.

#### 4.222 Elimination of a Disruptive Buyer

The elimination by vertical merger of a particularly disruptive buyer in a downstream market may facilitate collusion in the upstream market. If upstream firms view sales to a particular buyer as sufficiently important, they may deviate from the terms of a collusive agreement in an effort to secure that business, thereby disrupting the operation of the agreement. The merger of such a buyer with an upstream firm may eliminate that rivalry, making it easier for the upstream firms to collude effectively. Adverse competitive consequences are unlikely unless the upstream market is generally conducive to collusion and the disruptive firm is significantly more attractive to sellers than the other firms in its market.

The Department is unlikely to challenge a merger on this ground unless 1) overall concentration of the upstream market is 1800 HHI or above (a somewhat lower concentration will suffice if one or more of the factors discussed in Section 3.4 indicate that effective collusion is particularly likely), and 2) the allegedly disruptive firm differs substantially in volume of purchases or other relevant characteristics from the other firms in its market. Where the stated thresholds are met or exceeded, the Department's decision whether to challenge a merger on this ground will depend upon an individual evaluation of its likely competitive effect.

### 4.23 Evasion of Rate Regulation

Non-horizontal mergers may be used by monopoly public utilities subject to rate regulation as a tool for circumventing that regulation. The clearest example is the acquisition by a regulated utility of a supplier of its fixed or variable inputs. After the merger, the utility would be selling to itself and might be able arbitrarily to inflate the prices of internal transactions. Regulators may have great difficulty in policing these practices, particularly if there is no independent market for the product (or service) purchased from the affiliate.[35] As a result, inflated prices could be passed along to consumers as "legitimate" costs. In extreme cases, the regulated firm may effectively preempt the adjacent market, perhaps for the purpose of suppressing observable market transactions, and may distort resource allocation in that adjacent market as well as in the regulated market. In such cases, however, the Department recognizes that genuine economies of integration may be involved. The Department will consider challenging mergers that create substantial opportunities for such abuses.[36]

### 4.24. Efficiencies

As in the case of horizontal mergers, the Department will consider expected efficiencies in determining whether to challenge a vertical merger. See Section 3.5 (Efficiencies). An extensive pattern of vertical integration may constitute evidence that substantial economies are afforded by vertical integration. Therefore, the Department will give relatively more weight to expected efficiencies in determining whether to challenge a vertical merger than in determining whether to challenge a horizontal merger.

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[35]A less severe, but nevertheless serious, problem can arise when a regulated utility acquires a firm that is not vertically related. The use of common facilities and managers may create an insoluable cost allocation problem and provide the opportunity to charge utility customers for non-utility costs, consequently distorting resources allocation in the adjacent as well as the regulated market.

[36]Where a regulatory agency has the responsibility for approving such mergers, the Department may express its concerns to that agency in its role as competition advocate.