

Revising the VMGs

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Key Suggested Revisions to Draft VMGs

- **Set enforcement standard at “reasonable probability” of competitive harm**
 - This reflects the incipency standard’s concern with false negatives, and the case law (*AT&T*)
 - Empirical evidence does *not* support a procompetitive presumption or loose enforcement (*Scott Morton/Beck*)
 - Vertical mergers raise inherent horizontal concerns just like horizontal mergers (*Moresi/Salop*)
 - Unilateral Input Foreclosure in effect involves reducing head-to-head competition between the downstream affiliate and its rivals
 - Coordination concerns same as horizontal mergers.
- **Include full list of competitive harm concerns, including examples**
- **Delete safe harbor, but flag conditions when merger raises heightened vs lessened concerns**
 - 20%-20% shares standard lacks economic basis and leads to inevitable false negatives
 - Premature to set safe harbors during enforcement regime transition period
 - Real guidance requires discussion of both ends of concern continuum – “heightened” vs “lessened” concerns
- **Clarify determination of “related product segment”**
 - *E.g.*, Input foreclosure segment must focus on actual & potential suppliers of foreclosed rivals, *not necessarily all upstream firms*
- **Restructure EDM as an efficiency benefit that eliminates free riding incentives and combine with Section 8 (efficiencies)**
 - Burden on parties to show EDM is “cognizable” and “sufficient to reverse harms” with credible evidence, as case law dictates
 - Sufficient EDM is not inevitable – multiple models and impediments to significant merger-specific EDM
 - Proposed Merger-Specificity Standard: Whether EDM could be achieved practically absent the merger
- **Do not require quantification of harms**
 - Quantification raises the burden on Agencies and creates false negatives; not required by case law
 - Quantification focuses inquiry on limited issues

Sources and Details: Comments on draft VMGs by: Baker et al; Beck & Scott Morton; Moresi & Salop:

Input Foreclosure “Inherently” Reduces Horizontal Competition Downstream

- **Common claim: Horizontal mergers lead to an inherent reduction in competition, but vertical mergers do not.**
- ***This claim is clearly economically incorrect when input foreclosure is a concern.***
- **Pre-merger world involves “indirect competition” between upstream merging firm and downstream merging firm**
 - By selling inputs to downstream rivals, upstream merging firm “supports” downstream competition
- **Vertical merger changes incentives - and eliminates this support and indirect competition**
 - Raises rivals’ costs and thus reduces competition between rivals and downstream merging firm
 - This is an indirect, but inherent harmful effect
 - *Just like loss of head-head competition in horizontal mergers*
- **UPP analysis shows this inherent horizontal effect**
 - Vertical GUPPIs are identical to modified horizontal GUPPIs from partial ownership between downstream merging firm and foreclosed rivals
- **Vertical vGUPPIs translate into an equivalent increase in modified HHIs (*delta mHHI*)**
 - This is another way to see the inherent reduction in competition
 - This delta mHHI also might be used as a screen

Source: Moresi/Salop Comment on Draft VMGs

EDM Should Be Treated Like Other Efficiencies

- **Some seminal economic models lack either EDM or EDM/RRC correlation**
 - No EDM in Hart & Tirole model commitment model
 - No EDM in OSS input foreclosure model; Upstream firm typically is not a monopolist and accommodating price increases by competitors enhance RRC
 - No EDM benefits when merger facilitates coordination as in Nocke & White coordination models
- **Real world EDM benefits may not occur or may be insufficient to offset RRC or other harms when ...**
 - Upstream affiliate supplies downstream rivals, which creates UPP and may lead to accommodation (Moresi & Salop; Chen)
 - Pre-merger competition has driven down margin (Hart/Tirole & OSS)
 - Merger leads to pricing coordination, which limits output (Nocke & White)
 - Pre-merger EDM achieved by contract (Coase)
 - Incompatible inputs, switching costs or other costs deter internal transfers (Atalay et al)
 - Corporation structures its divisions as arm's-length players (Bonanno & Vickers)
 - Upstream affiliate has limited capacity or rising marginal cost
 - Downstream demand is inelastic
- **Proof that EDM benefits are merger-specific (*per HMGs definition*) should require credible evidence, including ...**
 - *Note: General or conclusory claim of “bargaining frictions” should be insufficient evidence*
 - Negotiation attempted and failure occurred
 - Merging firms internalize EDM for other inputs or spillovers for substitute/complementary products
 - Other competing firms fail to not achieve EDM pre-merger
 - *But*, Impediments from anticompetitive agreements or coordination should not be credited
 - Firms base executive compensation on Corporate profits not just Division profits
- **Downstream EDM price benefits should be non-cognizable “out of market” efficiencies when merger reduces upstream relevant market competition (coordination or customer foreclosure)**

20%-20% Safe Harbor Would Lead to Systematic False Negatives and Should be Erased

- **20% share thresholds make no economic sense**
 - Example A: Upstream “related product” shares are merging firm U1= 15% and competitor U2=85%. Foreclosure by U1 of all downstream rivals would lead U2 to raise price to all, which would cause diversion to merging firm D1. Even if D1’s share is less than 20%, it benefits from substantial diversion. (Or a few upstream firms accommodating the price increase as a standard “best response” just expected in a horizontal merger in a concentrated oligopoly market.)
 - Example B: Upstream related product shares are 10-20% for 7 firms. But, the technology of D1’s closest competitor D2 requires inputs only from U1 or U2. U1’s foreclosure of D2 leads U2 to raise price to D2, which cause diversion to D1.
 - Example C: D1 share is 15% but it is a disruptive input buyer that prevents upstream coordination. Or, share is 15% but it is a maverick that prevents upstream coordination. The vertical merger thus can facilitate upstream coordination, so U1’s profits rise. D1’s cost does not rise, so its profits do not fall. In fact, they can increase because rivals’ costs rise.
- **Basing safe harbor on pre-merger concentration levels would be better, but still subject to false negative errors, particularly because it lacks any metric of the potential effect of the merger**
 - Moresi & Salop Comment suggests “delta mHHI” metric for gauging increase in “effective concentration” from unilateral input foreclosure.
- **Anticompetitive presumptions also would provide useful guidance, especially for dominant network mergers**
- **Possible approach: Follow *Leegin* -- Defer bright line standards until Agencies gain experience with new VMGs**

Quantification Should Not Be Required

- **Has a valid place, but should not be treated as always necessary**
- **Not required by the case law**
 - But, may lead courts to require it too, if required in Agency investigations
- **Focuses the analysis only on issues that can be quantified, and away from ones that cannot, even if the latter ones are very important**
 - E.g., innovation; coordinated effects; potential entry.
- **Raises the Agency's burden and creates false negatives**
 - Econometrics and simulation models are “noisy,” particularly when they are used together.
 - Results can be very sensitive to the structure of the model, data, etc.
 - Statistical significance tests focused on avoiding false positives, not false negatives
 - No limit to complexity and complaints that parties side can raise to try to rebut results
 - Judges' may lack time, interest or ability to evaluate the weight that models and criticisms deserve