

U.S. DEPARTMENT OF JUSTICE AND THE FEDERAL TRADE COMMISSION

DRAFT VERTICAL MERGER GUIDELINES

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1. OVERVIEW

These Guidelines outline the principal analytical techniques, practices and enforcement policy of the Department of Justice and the Federal Trade Commission (the “Agencies”) with respect to vertical mergers and acquisitions (“vertical mergers”) under the federal antitrust laws.¹ The relevant statutory provisions include Section 7 of the Clayton Act, 15 U.S.C. § 18, Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§ 1–2, and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. Most particularly, Section 7 of the Clayton Act prohibits mergers if “in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.” This provision applies to vertical mergers², as Congress made plain in the 1950 amendments to the Clayton Act.

These Guidelines should be read in conjunction with the Horizontal Merger Guidelines.³ The principles and analytical frameworks used to assess horizontal mergers apply to vertical mergers. For example, Section 1 of the Horizontal Merger Guidelines—describing in general terms the purpose and limitations of the Horizontal Merger Guidelines and the goals of merger enforcement—is also relevant to the consideration of vertical mergers. Other topics addressed in the Horizontal Merger Guidelines, but not addressed herein, such as the analytic framework for evaluating entry considerations, the treatment of the acquisition of a failing firm or its assets, and the acquisition of a partial ownership interest, are relevant to the evaluation of the competitive

¹ These Guidelines supersede the extant portions of the Department of Justice’s 1984 Merger Guidelines, which are now withdrawn and superseded in their entirety. They reflect the ongoing accumulation of experience at the Agencies. These Guidelines may be revised from time to time as necessary to reflect significant changes in enforcement policy, to clarify existing policy, or to reflect new learning. These Guidelines do not cover horizontal or other types of non-vertical acquisitions.

² Vertical mergers combine firms or assets that operate at different stages of the same supply chain. Examples of vertical mergers include: a manufacturer acquiring one of the firms that supplies it with parts; or a retail chain buying the manufacturer of one of the consumer products that it sells. In describing a vertical relationship, the stage closer to final consumers (such as a distributor, retailer, or finished goods manufacturer) is termed “downstream,” and the stage farther from final consumers (such as a supplier, wholesaler, or input manufacturer) is termed “upstream.”

³ U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines (2010).

effects of vertical mergers as well. Vertical mergers, however, also raise distinct considerations, which these Guidelines address.

These Guidelines are intended to assist the business community and antitrust practitioners by increasing the transparency of the analytical process underlying the Agencies' enforcement decisions. They may also assist the courts in developing an appropriate framework for interpreting and applying the antitrust laws in the vertical merger context.⁴

2. MARKET DEFINITION AND RELATED PRODUCTS

In any merger enforcement action involving a vertical merger, the Agencies will normally identify one or more relevant markets in which the merger may substantially lessen competition. Many of the general purposes and limitations of market definition described in Section 4 of the Horizontal Merger Guidelines are also relevant when the Agencies define markets for vertical mergers, and the Agencies use the methodology set forth in Sections 4.1 and 4.2 of the Horizontal Merger Guidelines to define relevant markets for vertical mergers.

When the Agencies identify a potential competitive concern in a relevant market, they will also specify one or more related products. A related product is a product or service that is supplied by the merged firm, is vertically related to the products and services in the relevant market, and to which access by the merged firm's rivals affects competition in the relevant market. A related product could be, for example, an input, a means of distribution, or access to a set of customers.

Example 1: A retail chain buys a manufacturer of cleaning products. In this example, the Agencies may identify two relevant markets. The first potential relevant market is the supply of cleaning products to retail customers in a given geographic area. For this relevant market, the related product is the supply of the cleaning products by the manufacturer to retailers in the geographic area. The second potential relevant market is the supply of cleaning products to retailers in a given geographic area. For this relevant market, the related product is the purchase or distribution of that manufacturer's cleaning products to sell to retail customers in the geographic area.

⁴ These Guidelines are not intended to describe how the Agencies will conduct the litigation of cases they decide to bring. Although relevant in that context, these Guidelines neither dictate nor exhaust the range of evidence the Agencies may introduce in litigation.

3. MARKET PARTICIPANTS, MARKET SHARES, AND MARKET CONCENTRATION

The Agencies may consider measures of market shares and market concentration in a relevant market as part of their evaluation of competitive effects. The Agencies evaluate market shares and concentration in conjunction with other reasonably available and reliable evidence for the ultimate purpose of determining whether a merger may substantially lessen competition.

The Agencies use the methodology set out in Sections 5.1, 5.2 and 5.3 of the Horizontal Merger Guidelines to measure shares and concentration in a relevant market, but do not rely on changes in concentration as a screen for or indicator of competitive effects from vertical theories of harm.

The Agencies may also consider measures of the competitive significance of the related products as part of their evaluation of competitive effects in a relevant market. One such measure may be the share of the output in a relevant market that uses the related products. If the related products are used in a smaller share of sales in the relevant market the merged firm's control of the related products may be less likely to have substantial effects on competition in the relevant market.

Example 2: Company A is a wholesale supplier of orange juice. It seeks to acquire Company B, an owner of orange orchards. The Agencies may consider whether the merger would lessen competition in the wholesale supply of orange juice in region X (the relevant market). The Agencies may identify Company B's supply of oranges as the related product. Company B's oranges are used in fifteen percent of the sales in the relevant market for wholesale supply of orange juice. The Agencies may consider the share of fifteen percent as one indicator of the competitive significance of the related product to participants in the relevant market.

The Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market.

In some circumstances, mergers with shares below the thresholds can give rise to competitive concerns. For example, the share of the relevant market that uses the related product may understate the scope for material effects if the related product is relatively new, and its share of use in the relevant market is rapidly growing. Moreover, a share of 20 percent or more in the relevant market or a related products' share of use in the relevant market of 20 percent or more, or both, does not, on its own, support an inference that the vertical merger is likely to substantially lessen competition. The purpose of these thresholds is not to provide a rigid screen to separate competitively benign mergers from anticompetitive ones. Rather, they provide one way to identify some mergers unlikely to raise competitive concerns and some others for which it is particularly important to examine other competitive factors to arrive at a determination of likely competitive effects.

4. EVIDENCE OF ADVERSE COMPETITIVE EFFECTS

The Agencies consider any reasonably available and reliable evidence to address the central question of whether a vertical merger may substantially lessen competition. The types of evidence described in Section 2.1 of the HMG can also be informative about the effects of vertical mergers, including: actual effects observed in consummated mergers, direct comparisons based on experience, and evidence about the disruptive role of a merging party. Pre-existing contractual relationships may affect a range of relevant market characteristics. The Agencies also consider market shares and concentration in relevant markets and related products (see Section 3), and may rely on evidence about head to head competition between one merging firm, and rivals that trade with the other merging firm, when evaluating unilateral effects (see Section 5). The sources of evidence the Agencies rely on are the same as those set forth in Section 2.2 of the Horizontal Merger Guidelines and include documents and statements of the merging parties, their customers, and other industry participants and observers.

5. UNILATERAL EFFECTS

A vertical merger may diminish competition between one merging firm and rivals that trade with, or could trade with, the other merging firm. Whether the elimination of double marginalization resulting from the merger, or cognizable efficiencies, are likely to reduce or reverse the adverse unilateral effects, is addressed in Sections 6 and 8.

This section discusses common types of unilateral effects arising from vertical mergers. Section (a) discusses foreclosure and raising rivals' costs. Section (b) discusses competitively sensitive information. These effects do not exhaust the types of possible unilateral effects.

a. Foreclosure and Raising Rivals' Costs

A vertical merger may diminish competition by allowing the merged firm to profitably weaken or remove the competitive constraint from one or more of its actual or potential rivals in the relevant market by changing the terms of those rivals' access to one or more related products. For example, the merged firm may be able to raise its rivals' costs by charging a higher price for the related products or by lowering service or product quality. The merged firm could also refuse to supply rivals with the related products altogether ("foreclosure").

Where sufficient data are available, the Agencies may construct economic models designed to quantify the likely unilateral price effects resulting from the merger. These models often include independent price responses by non-merging firms. They also can incorporate the elimination of double marginalization (see Section 6) to give a likely net effect from changes to pricing incentives, as well as incorporate cognizable efficiencies (see Section 8). These merger simulation methods need not rely on market definition. The Agencies do not treat merger simulation evidence as conclusive in itself, and they place more weight on whether their merger simulations consistently predict substantial price increases than on the precise prediction of any single simulation.

A vertical merger may diminish competition by making it profitable for the merged firm to foreclose rivals in the relevant market by denying them access to a related product. Alternatively,

the merger may increase the incentive or ability of the merged firm to raise its rivals' costs or decrease the quality of their rivals' products or services, thereby reducing the competitive constraints imposed by those rival firms. In identifying whether a vertical merger is likely to result in unilateral harm to competition through foreclosure or raising rivals' costs, the Agencies may consider whether:

- (1) The merged firm's foreclosure of, or raising costs of, one or more rivals would cause those rivals to lose sales (for example, if they are forced out of the market, if they are deterred from innovating, entering or expanding, or cannot finance these activities, or if they have incentives to pass on higher costs through higher prices), or to otherwise compete less aggressively for customers' business;
- (2) The merged firm's business in the relevant market would benefit (for example if some portion of those lost sales would be diverted to the merged firm);
- (3) Capturing this benefit through merger may make foreclosure, or raising rivals' costs, profitable even though it would not have been profitable prior to the merger; and,
- (4) The magnitude of likely foreclosure or raising rivals' costs is not *de minimis* such that it would substantially lessen competition.

Mergers for which each of these conditions are met potentially raise significant competitive concerns and often warrant scrutiny. The next paragraphs provide illustrative examples of the application of this general framework to different settings.

Example 3: In Example 2, the merged firm may be able to profitably stop supplying oranges (the related product) to rival orange juice suppliers (in the relevant market). The merged firm will lose the margin on the foregone sales of oranges but may benefit from increased sales of orange juice if foreclosed rivals would lose sales, and some of those sales were diverted to the merged firm. If the benefits outweighed the costs, the merged firm would find it profitable to foreclose. If the likely effect of the foreclosure were to substantially lessen competition in the orange juice market, the merger potentially raises significant competitive concerns and may warrant scrutiny.

Example 4: Company A supplies a component (the related product) to Companies B and C, which each use to make final products in a downstream market (the relevant market). Companies A and B merge. When the merged firm bargains with Company C over the price of the related product, it may be more willing to hold out for higher prices compared to an unintegrated Company A because losing (or delaying) sales of the related product to Company C may be more costly for standalone Company A than for the merged firm. Higher prices paid by Company C for the related product may lead to higher downstream prices.

Example 5: Company A is the sole supplier of an active ingredient (the related product) for a pharmaceutical drug made by Company B (the relevant market). Company C is considering entering the relevant market. If Company B buys Company A, the merged firm may find it profitable to refuse to supply the ingredient to any rivals or potential rivals if doing so would deter Company C from entering, or prevent it from financing entry, by requiring it to start producing both the active ingredient and the drug at the same time (two stage entry). If refusing to supply entrants was profitable for the merged firm, and if the likely result was that competition in the relevant market would be substantially lessened compared to the level that would have obtained absent the merger, the merger potentially raises significant concerns and may warrant scrutiny.

Example 6: Company A distributes wholesale consumer cleaning products to retailers (the relevant market). It buys Company B, which makes one of the brands that Company A distributes. The merged firm may find it profitable to raise the price of wholesale distribution of rival brands (the related products) after the merger, even if the price rise was not profitable for the unintegrated Company A. As a result of the merger, the merged firm captures the upstream margin on any sales that are diverted from rival brands to Company B's brand. If the merged firm has a sufficiently important position in the relevant market, and the price rise it imposes on the wholesale distribution of rival brands is sufficiently high, competition may be substantially lessened compared to the level that would have obtained absent the merger, the merger potentially raises significant concerns and may warrant scrutiny.

b. Access to Competitively Sensitive Information

In a vertical merger, the combined firm may, through the acquisition, gain access to and control of sensitive business information about its upstream or downstream rivals that was unavailable to it before the merger. For example, a downstream rival to the merged firm may have been a premerger customer of the upstream firm. Post-merger, the downstream component of the merged firm could now have access to its rival's sensitive business information. Access to a rival's competitively sensitive information can, in some circumstances, be used by the merged firm to moderate its competitive response to its rival's competitive actions, for example it may preempt or react quickly to a rival's procompetitive business actions. Under such conditions, rivals may see less competitive value in taking procompetitive actions. Relatedly, rivals may refrain from

doing business with the merged firm rather than risk that the merged firm would use their competitively sensitive business information as described above. They may become less effective competitors if they are forced to rely on less preferred trading partners, or if they pay higher prices because they have fewer competing options.

6. ELIMINATION OF DOUBLE MARGINALIZATION

Elimination of double marginalization can occur when two vertically related firms that individually charge a profit-maximizing margin on their products choose to merge. Absent the merger, the downstream merging firm would ignore any benefit to the upstream merging firm from setting a lower downstream price and making higher sales. But if the two merge, the resulting firm will benefit from both margins on any additional sales, and capturing the upstream margin, through merger, may make the price reduction profitable even though it would not have been profitable prior to the merger. Elimination of double marginalization may thus benefit both the merged firm and buyers of the downstream product or service.

The agencies generally rely on the parties to identify and demonstrate whether and how the merger eliminates double marginalization. There will be no elimination of double marginalization if the downstream firm cannot use the inputs from the upstream one, for example, because it uses an incompatible technology. The effects of the elimination of double marginalization may be lower if, prior to the merger, the merging parties already engaged in contracting that aligned their incentives, for example by using a two-part tariff with a fixed fee and low unit prices that incorporate no, or a small, margin. The effects of the elimination of double marginalization in the downstream market may also be offset by a change in pricing incentives working in the opposite direction: if the merged firm raises its price in the downstream market, downstream rivals may increase their sales, which could increase their demand for inputs from the merged firm's upstream business. Capturing this benefit through merger may make the downstream price increase more profitable.

The Agencies will not challenge a merger if the net effect of elimination of double marginalization means that the merger is unlikely to be anticompetitive in any relevant market.⁵

⁵ The Agencies may also consider elimination of double marginalization that is not strictly in the relevant market, using the principles set out in footnote 14 of the Horizontal Merger Guidelines for efficiencies that are inextricably linked.

7. COORDINATED EFFECTS

In some cases, a vertical merger may diminish competition by enabling or encouraging post-merger coordinated interaction among firms in the relevant market that harms customers. Section 7 of the Horizontal Merger Guidelines describes how the Agencies evaluate coordinated effects. In particular, Section 7.1 notes that the Agencies are more likely to challenge a merger on the basis of coordinated effects when the relevant market shows signs of vulnerability to coordinated conduct, and the Agencies have a credible basis on which to conclude that the merger may enhance that vulnerability. Section 7.2 sets forth evidence relevant to evaluating whether a market is vulnerable to coordination. The theories of harm discussed in the Horizontal Merger Guidelines, as well as those discussed below, are not exhaustive, but rather are illustrations of the manner in which a merger may lessen competition due to coordinated effects.

A vertical merger may enhance the market's vulnerability to coordination by eliminating or hobbling a maverick firm that otherwise plays or would play an important role in preventing or limiting anticompetitive coordination in the relevant 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.

Coordinated effects may also arise in other ways, including when changes in market structure or the merged firm's access to confidential information facilitate (a) reaching a tacit agreement among market participants, (b) detecting cheating on such an agreement, or (c) punishing cheating firms.

Example 7: The merger brings together a manufacturer of components and a maker of final products. If the component manufacturer supplies rival makers of final products, it will have information about how much they are making, and will be better able to detect cheating on a tacit agreement to limit supplies. As a result the merger may make the tacit agreement more effective.

Some effects of a vertical merger may make the market less vulnerable to coordination. For example, a vertical merger's elimination of double marginalization (see Section 6) may increase the merged firm's incentive to cheat on a tacit agreement, thereby reducing the risk of coordinated effects.

8. EFFICIENCIES

Because vertical mergers combine complementary economic functions and eliminate contracting frictions, they have the potential to create cognizable efficiencies that benefit competition and consumers. Vertical mergers bring together assets used at different levels in the supply chain to make a final product. A single firm able to coordinate how these assets are used may be able to streamline production, inventory management, or distribution, or create innovative products in ways that would have been hard to achieve through arm's length contracts.

The Agencies will evaluate efficiency claims by the parties using the approach set forth in Section 10 of the Horizontal Merger Guidelines. The Agencies do not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is unlikely to be anticompetitive in any relevant market.