Final Review Session

Summary: Nonhorizontal Mergers

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Topics

- Elimination of potential competition
  - Actual potential competition
  - Perceived potential competition
  - “Potential expander” cases
  - Nascent competition
- Vertical mergers
  - Foreclosure/RRC
  - Anticompetitive information conduits
  - Coordinated effects

For each theory, know—

1. The competitive harm
2. The theory's requirements (elements)
3. The defenses
4. Possible relief or "fixes"

Eliminating Potential Competition

Eliminating actual potential competition

- The competitive harm
  - *Definition*: An actual potential entrant is a firm that, in the absence of the acquisition, would likely enter the relevant market in the near future
  - *Harm*: An acquisition involving an incumbent firm and an actual potential entrant eliminates the prospect of entry and, with it, the improvement in the competitive performance of the relevant market if the entry had occurred
  - *Observations*
    - The actual potential entrant may be either the acquiring firm or the target
    - "In the near future" is not well defined
      - Court decisions in the 1970s generally regarded "in the near future" to mean within two-three years
      - FTC challenges since then have adopted a less rigid approach: "In the near future" appears to mean the time period in which likely entry is predictable with some confidence
        - In prescription drugs, for example, where the FDA approval process determines whether and when entry will occur, FTC sees drugs in Phase II or Phase III clinical trials to be actual potential entrants.
        - FDA approval beginning with Phase II takes about seven years on average, but only 30% of Phase II drugs succeed.
    - Court approval
      - The Supreme Court has not recognized the elimination of actual potential competition as a cognizable Section 7 harm—BUT it is expected to do so when a case presents the issue
      - Lower courts entertain the theory, but no modern court has found a violation on the merits

Eliminating actual potential competition

- Five elements of the actual potential competition theory of harm
  1. *Noncompetitiveness*: The relevant market is operating noncompetitively
     - Usually presumed when the market is "highly concentrated" under the Merger Guidelines
  2. *Uniqueness*: The actual potential entrant must be one of few firms, or the most likely firm, positioned to enter the market in a timeframe of interest
  3. *Ability*: The actual potential entrant must have an "available, feasible means" of procompetitive entry
  4. *Incentive/likelihood of entry*: In the absence of the acquisition, the actual potential entrant would likely enter the relevant market "in the near future"
     - Objective evidence is the most reliable (e.g., board approvals, planning documents)
     - Courts consider subjective evidence much less reliable (especially testimony by the putative entrant's representatives that the firm would not enter)
  5. *Procompetitive effect*: If the actual potential entrant entered the market, it would enter in a way that likely would materially improve the competitive performance of the market

Different courts articulate the elements somewhat differently, but they all can be unpacked into these five elements

Eliminating actual potential competition

- Remedies
  - Typically, requires the divestiture of the incumbent product
  - Divestiture of assets of the actual potential entrant can be problematic—
    - Oftentimes, little to divest from the actual potential entrant (especially if only in the planning stages)
    - May be difficult to ascertain the commitment of the divestiture buyer to enter or the degree of success it is likely to have
  - Exception: When—
    1. There are substantial assets related to entry to be divested, *and*
    2. There is strong reason to believe that the divestiture buyer will have at least as much success in entering as the divestiture seller in the same time period

    the agencies will accept the divestiture of entry-related assets

- The practice
  - Although modern courts have not found for the government under this theory, the agencies have used the theory to obtain divesture consent decrees when—
    1. The alleged target market is highly concentrated,
    2. There are few if any other similar or better situated actual potential entrants, *and*
    3. Entry by the putative actual potential entrant is almost certain in the immediate future

Eliminating perceived potential competition

- The competitive harm
  - *Definition*: A perceived potential entrant is a firm that incumbent firms—
    - Perceive is ready to enter the market, and
    - Moderate their anticompetitive behavior (act more competitively) than they would in the absence of the putative entrant in order to discourage entry
  - *Harm*: An acquisition involving an incumbent firm and a perceived potential entrant eliminates the perceived prospect of entry and, with it, the need for incumbent firms to moderate their anticompetitive behavior, reducing the competitive performance of the relevant market
  - *Observations*
    - Held by the Supreme Court to be a cognizable theory of Section 7 harm
    - Does NOT require the perceived potential entrant to be an actual potential entrant
      - It is the *perception* of prospective entry that is competition-inducing, not the reality of entry
    - Limit pricing (that is, pricing below the level likely to precipitate entry) is regarded as the canonical form of moderating behavior
    - Few if any modern cases challenged on this theory
      - Almost impossible to prove that incumbent firms have moderated their anticompetitive behavior in order to discourage entry

Eliminating perceived potential competition

- Five elements of the perceived potential competition theory of harm
  1. *Noncompetitiveness*: The relevant market must be susceptible to operating noncompetitively
     - Usually presumed when the market is “highly concentrated” under the Merger Guidelines
  2. *Perception*: Incumbent firms must perceive the firm as a likely potential entrant
  3. *Uniqueness*: The perceived potential entrant must be one of few firms whose potential entry incumbents view as sufficiently likely and threatening to influence their competitive conduct
  4. *Incumbent reaction*: Incumbent firms must be responding premerger to the perceived threat of entry by lowering their prices (“limit pricing”), improving their product quality, or engaging in some other procompetitive activities all discourage the entry of the perceived potential entrant
     - Objective evidence is the most reliable (e.g., an incumbent’s strategy documents expressing concern about perceived potential entry and the moderating behavior the incumbent has taken in response)
     - Courts consider subjective evidence much less reliable
  5. *Anticompetitive effect*: Removing the perceived threat of entry through the acquisition of the perceived potential entrant must likely result in incumbent firms ceasing some or all their procompetitive entry-deterring conduct and so lessen competition in the relevant market postmerger

Eliminating perceived potential competition

- Remedies
  - There is no remedy to preserve competition in a perceived competition case other than enjoining the acquisition

Eliminating a "potential expander"

- The competitive harm
  - *Definition*: A "potential expander" is a small firm in the relevant market that, in the absence of the acquisition, would likely expand in the near future to be a significant independent competitive force in the relevant market
  - *Harm*: An acquisition involving an incumbent firm and a "potential expander" eliminates the prospect of that the potential expander will become a significant competitive force in the future, with it, the improvement in the competitive performance of the relevant market if the expansion had occurred
  - *Observations*
    - The "potential expander" theory is a variant of the actual potential competition doctrine, with the "potential expander" replacing the actual potential entrant
    - With this substitution, all the requirements of the actual potential competitive doctrine apply as do the remedies

Eliminating a nascent competitor

- The competitive harm
  - *Definition*: A “nascent competitor” is a firm that has the potential present a serious threat in the future to a dominant firm
    - The threat usually resides in the nascent competitor’s development of a new technology or a new product that could possibly shift share away from the dominant firm
    - The competition may come from the original developer, an acquirer or a developer of the new technology
  - *Harm*: Identical to the harm when eliminating an actual potential entrant

Eliminating a nascent competitor

- The competitive harm
  - *Observations*:
    - By their nature, “nascent competitors” fail to satisfy the requirements of the actual potential competitive doctrine
      - At the time of the acquisition, the nascent competitor may not be actively considering entering the market with a product competitive with the acquiring dominant firm
      - It may be uncertain that, in the absence of the acquisition, the nascent competitor would create a product competitive with the dominant firm
      - Even if the nascent competitor contemplates entry with a competitive product, the timing for entry may be much more distant that in “the near future”
      - Even if the nascent competitor contemplates entry in the near future, the technological and commercial success of this entry—and the competitive impact of entry—may be highly speculative
    - Judicial acceptance
      - The theory is untested in the courts
      - Under the further rigid requirements of the actual potential doctrine, it does not appear very likely that the doctrine makes the acquisition of a “nascent competitor” actionable under Section 7
      - Proponents of the theory argue that the acquisition of a nascent competitor by the dominant firm that is putatively threatened constitutes an anticompetitively exclusionary act that can predicate a Section 2 monopolization or attempted monopolization claim

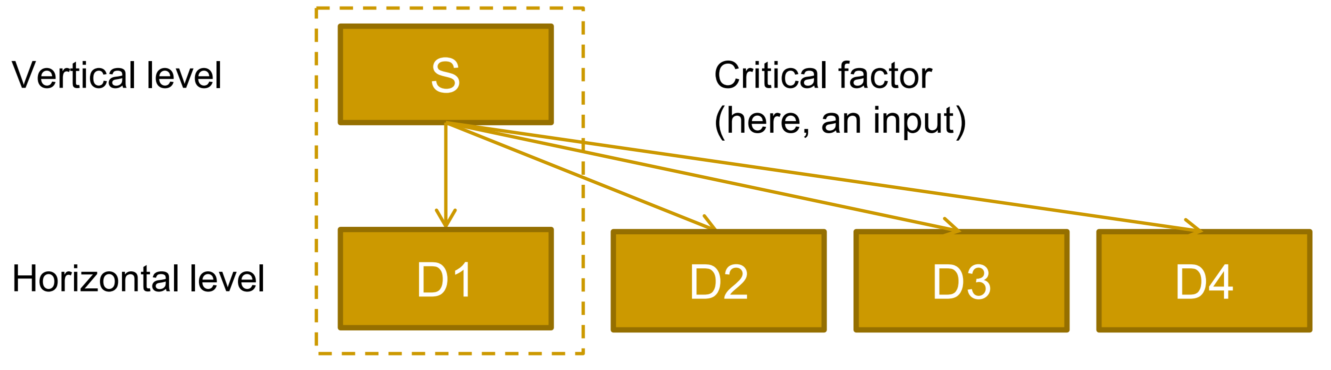
Eliminating a nascent competitor

- Requirements (largely undefined)
- Remedies
  - There is no remedy to nascent competition other than to enjoin the acquisition

Vertical Mergers

Foreclosure/RRC

- Some definitions
  - *Critical factor:* The scarce input or output that the vertically merged firm controls that it can use to harm it rivals at the horizontal level
  - *Vertical level*: The level in the chain of manufacture and distribution at which the vertically merged firm produces the critical factor
  - *Horizontal level*: The level in the chain of manufacture and distribution where the rival that deal with the merged firm operate
  - Example:



Foreclosure/RRC

- *The competitive harm*:
  - The merger—
    1. Gives the merged firm control over an input or an output at one level that is competitively significant to the merged firm's rivals at the other level,
    2. Which can be used to lessen competition in the relevant market containing the rivals
  - *Input foreclosure*: The merged firm controls the supply of an input at the upstream level that is competitively significant to the merged firm's rival at the downstream level
    - *Example*: The merger involves one of the few lithium suppliers with a lithium battery manufacturer. The merged firm can restrict the supply of lithium and competitively disadvantage rivals in lithium battery manufacturing.
  - *Output foreclosure*: The merged firm controls an essential factor at the downstream level that is competitively significant to the merged firm's rivals at the upstream level
    - *Example*: the merger involves a dental implant manufacturer and one of the three companies that distributes dental implants to dentists. The merged firm can restrict access by its manufacturing rivals to its distribution company

Foreclosure/RRC

- *Observations*:
  - It does not matter to the analysis whether the upstream or downstream level of the merged firm controls the essential factor
  - "Foreclosure" under this theory can mean either—
    - Complete foreclosure (a refusal to deal), or
    - Raising rivals' costs (RRC), where the merged firm continues to deal with the rivals but charges them a higher price (for input foreclosure) and demand a lower price (for output foreclosure)
  - Vertical theories of foreclosure/raising rivals' costs are often about *incentives* rather than the *ability* of the merged firm to harm competition
    - Premerger, the firm controlling the essential factor had the ability to refuse or deal or alter its prices and made its decisions so as to maximize its own profits
    - Postmerger, the merged firm will also act in its own profit-maximizing interest, recognizing that altering its price of the essential factor may have the effect of diverting some of its rivals' customers to the merged firm
    - The question of whether and to what degree the merged firm will change the terms on which it deals on the essential factor depends on whether the losses the merged firm sustains at that level are outweighed by the profits its making from capturing the customers of its rivals at the horizontal level

Foreclosure/RRC

- Requirements
  1. *Critical factor control*: The merger must involve one firm that controls a factor (e.g., an input or distribution channel) critical to the rivals of the other firm in the merger
  2. *Ability to foreclose:* The merged firm must have the ability to restrict rivals' access to critical inputs or critical outputs
     - This requires that rivals cannot access the critical factors at premerger terms from existing third parties to merger, new firms that enter the critical factor market, or vertical integration by the foreclosed firm into the critical factor
     - This element may be presumed from the merged firm having market power in the market for the critical factor
  3. *Incentive to foreclose*: The merged firm must have the profit-maximizing incentive to exercise its ability to foreclose
     - This depends on whether the losses the merged firm sustained at the critical factor level from foreclosing its rivals is more than offset by the gains it makes by capturing diverting customers from its rivals
  4. *Reduction in market competitive performance*: The foreclosure must significantly harm rivals' ability to compete, such as by increasing their costs or limiting their access to a substantial portion of the market, hereby reducing competition in that relevant market

Foreclosure/RRC

- Defenses
  1. There is no critical factor
     - Rivals can substitute another factor for the putative critical factor without loss of competitiveness
  2. The merged firm cannot restrict access to the critical factor
     - Although critical to rivals, the factor can be obtained at premerger terms from—
       a. Existing third-party firms
       b. New firms that enter the market in response to the shortage created by the merged firm's restrictions on the critical factor
       c. Vertical integration by the foreclosed firms (either individually or through a joint venture) into the foreclosed factor
     - Some merging firms have successfully sought to preempt their ability to foreclose rivals by entering into long-term contracts to provide access to the critical factor
  3. The merged firm has no incentive to foreclose
     - The merged firm believes that its profit-maximizing business strategy is to maintain or expand its supply of the critical factor to its rivals, not restrict it
       - This typically comes down to a battle between—
         - The evidence provided by the merging firm of the merged firm's profit-maximizing strategy, and
         - The economic models provided by the plaintiff's expert economists
       - Modern courts have been convinced by the business testimony and rejected the economic models

Foreclosure/RRC

- Defenses (con't)
  4. Offsetting efficiencies through the elimination of double marginalization
     - The merged firm, in principle, can increase its profits by eliminating the double markup that the merging firms each charged premerger, resulting in expanded output and lower prices for the merged firm's customers (and increased profits for the merged firm)
     - The idea (à la AT&T/Time Warner) is that the merger does not violate Section 7 if—
       - The gains to the merged firm's customers from lower prices
       - Are greater than the losses to the customers of the merged firm's rival due to the restrictions on the critical factor[1]
     - There are at least three difficulties in successfully invoking this defense—
       a. The merged firm may not attempt to eliminate double margins, preferring instead to incentivize the executives of its upstream and downstream operations to independently maximize profits at their own respective levels
       b. A consumer gains and losses comparison requires the determination of the "pass through" rate to customers
       c. The "vertical arithmetic" is very sensitive to the magnitudes of the premerger margins, which can be difficult conceptually and practically to determine

[1] This is known in economics as the *Kaldor-Hicks compensation principle*. As far as I know, the EDM efficiencies defense has been invoked only in the more common case of input foreclosure. There is no reason why it could not be employed in cases of output foreclosure at the level of the ultimate customer.

Foreclosure/RRC

- Remedies
  - Historically
    - For much of modern antitrust history, the agencies accepted consent decree that prohibited foreclosure and required the merged firm to deal with its rival on “fair, reasonable, and nondiscriminatory terms”
    - Another method, employed in the Comcast/NBCUniversal consent decree, required the merged firm to deal with rivals ab initio, with any dispute over price or other terms to be resolved though mandatory arbitration
  - More recently
    - Since late in the Trump administration, the agencies have refused to accept behavioral consent decrees
    - Instead, they would accept consent settlements where the merging parties have to divest one of the two businesses that gave rise to the vertical foreclosure problem
    - Merging parties confronted with this demand have elected instead to litigate, and so far have prevailed (on no ability or no incentive defenses)

Foreclosure/RRC

- Vertical GUPPIs
  - Observations
    - In determining the profit-maximizing incentive of the merged vertical firm, the incremental profit formula is of the same form as the formula for incremental profits in recapture unilateral effects
    - The key difference is that the dollar margin is the recapture is the dollar margin of the merged firm ($\$m_{MF}$), not just the dollar margin of R1:

$$\$m_{MF} = \$m_M + \$m_{D1}$$

    - With an adjustment for the dollar margin, we can use the *GUPPI* formula for unilateral effects to create a *vGUPPI* for the vertical merger:

$$vGUPPI = D_{R2\to R1}\%m_{MF}\frac{p_{R1}}{p_M} = \frac{D_{R2\to R1}\$m_{MF}}{p_M},$$

In these problems, it is much easier to deal with $\$m_{MF}$ than $\%m_{MF}$

since $\$m_{MF} = \%m_{MF} * p_{R1}$

    - Proposition:

The profit-maximizing increase in the manufacturer's price to R2 is vGUPPI/2

Foreclosure/RRC

- Example

> Premerger, Manufacturer M sells 500 widgets to each of retailers R1 and R2 at a price of $100 per widget for a gross margin of 50%. R1 and R2 each sell widgets to customers at $140 per widget for a gross margin of 40%. Although M's widgets are not differentiated, the retailers are differentiated by location, level of customer service, and overall product mix. If R2 increases its price, 60% of the sales it loses divert to R1 as customers comparison shop assuming no change in R1's price. There is no arbitrage, so M can price discriminate in the prices its charges R1 and R2. If M and R2 merge, will M increase the price to R2 and, if so, by how much?

  - The merger of M and R1 is a vertical merger. The question asks whether M will engage in input RRC by increasing R2's price
    - The data

p_M	$100	p_{D1}	$140		
$\%m_M$	50%	$\%m_{D1}$	40%	D_{21}	60%
$\$m_M$	$50	$\$m_{D1}$	$56	$\$m_{MF}$	$106

    - vGUPPI

$$vGUPPI = \frac{D_{R2\to R1}\$m_{MF}}{p_M} = \frac{(0.60)(106)}{100} = 63.6\%$$

    - Profit-maximizing price increase to R2: vGUPPI/2 = 31.8% or $31.80, for a new R2 price of $131.80

Foreclosure/RRC

- Brute force calculation of incremental profits

Input RRC: M increases its price to R2 by (say) 20%

Price (p_M)	\$100.00	Data
$\%m_M$	50.00%	Data
Elasticity	2	$1/\%m_M$ (Lerner condition)
$\%SSNIP_{R2}$	20.00%	Data
$\$SSNIP_{R2}$	\$20.00	$\%SSNIP_{R2} * p_M$
q_{R2}	500	Data
$\%\Delta q_{R2}$	40.00%	$\%SSNIP_{R2}$ * elasticity (from elasticity definition)

By playing around with $\%SSNIP_{R2}$, you can find the profit-maximizing percentage price increase to R2

M's incremental inframarginal gain

$\$SSNIP_{R2}$	\$20.00	From above
Inframarginal units	300	$q_{R2} - \Delta q_{R2}$
	\$6,000.00	

M's incremental marginal loss

$\$m_M$	\$50.00	$p_{R2} * \%m_M$
Marginal units (Δq_{R2})	200	$\%\Delta q_{R2} * q_{R2}$
	\$10,000.00	

M's net incremental gain -\$4,000.00

Should be negative if M is profit-maximizing premerger

R1 recapture

p_{R1}	\$140.00	
$\%m_{R1}$	40.00%	
$\$m_{R1}$	\$56.00	Holding R1 retail price constant
$\$m_M$	\$50.00	
$\$m_{MF}$	\$106.00	$\$m_M + \$m_{R1}$
D_{21}	60.00%	Actual diversion ratio
Recaptured	120.00	$R_{21} * \Delta q_{R2}$
Recap gain	\$12,720.00	

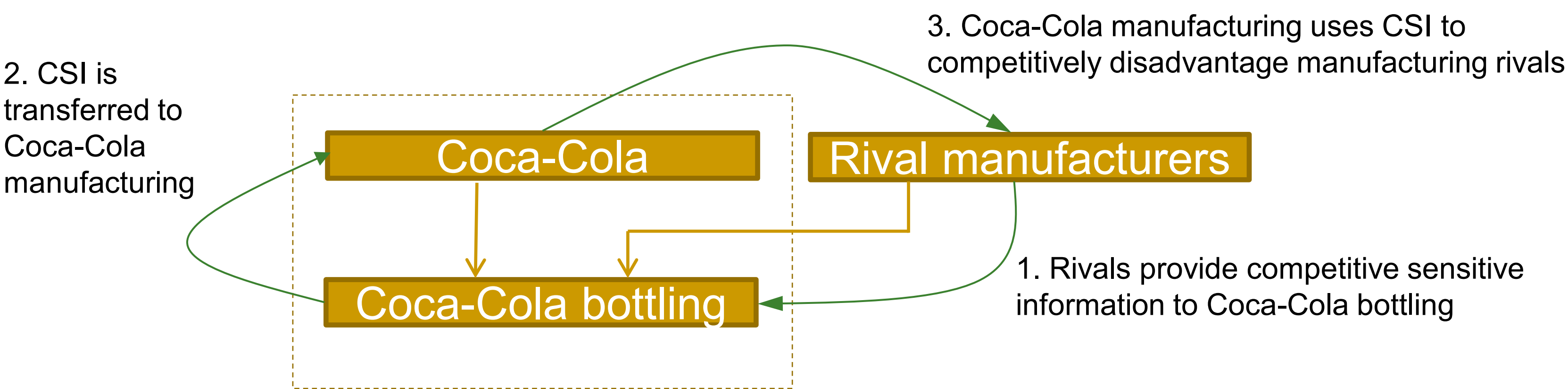
TOTAL INCREMENTAL PROFITS	**\$8,720.00**	
	\$10,112.40	Maximum incremental profits Achieved at $\%SSNIP_2$ = 31.80%

Anticompetitive information conduits

- The competitive harm
  - For efficient dealing, rivals at the non-critical factor level may have to provide competitively sensitive information (CSI) to the merged firm at the critical factor level
    - For example, CSI may include advance notice of price changes, product promotions, or future product innovations
  - Vertical mergers can be anticompetitive if the merged firm obtains CSI from rivals through the vertical relationship and uses that information at the horizontal level to disadvantage those rivals and harm competition

Anticompetitive information conduits

- The competitive harm
  - *Example*: Coca-Cola's integrated bottler bottles soft drinks for rival concentrate manufacturers[1]
    1. Coca-Cola bottling obtains competitively sensitive information from the rival manufacturers in the course of its vertical bottling relationship
    2. The rivals' information is given to Coca-Cola
    3. Coca-Cola uses the information to competitively disadvantage its rivals, thereby reducing competition at the horizontal concentrate level



[1] *See* Coca-Cola Co., 150 F.T.C. 520 (Nov. 3, 2010) (settled by consent decree).

Anticompetitive information conduits

- Requirements
  1. *Access to rivals' competitively sensitive information*: The merged firm must gain access to non-public, competitively sensitive information from rivals at the vertical level
  2. *Ability to competitively disadvantage rivals*: The merged firm must have the ability to use this information at its horizontal level to disadvantage its rivals
  3. *Incentive to misuse information*: The merged firm must have the profit-maximizing incentive to exploit the obtained information to harm rivals at the horizontal level
  4. *Anticompetitive harm*: The use of the information must significantly harm rivals' ability to compete effectively in the relevant market, reducing competition and potentially leading to higher prices, reduced quality, or less innovation at the horizontal level

Anticompetitive information conduits

- Defenses
  - *Not CSI*
    - The information provided to the merged firm is not competitively sensitive because it—
      - Cannot be used to harm a rival, or
      - Is already publicly known
  - *No incentive to misuse the CSI*
    - The merged firm believes that its profit-maximizing business strategy is to maintain the confidentiality of the CSI at the vertical level to foster collaboration and make dealing with the rival attractive to horizontal rivals
      - That is, the firm believes it makes more profits by increasing business at the vertical level than it would by increasing business at the horizontal level by harming rivals while decreasing business at the vertical level
  - *Not anticompetitively harmful*
    - Although the CSI can be used against a rival, the CSI is not so competitively significant that it can be used to substantial lessen competition in the relevant horizontal market
  - Note on an efficiency defense
    - It is unlikely there is an efficiency defense to a vertical mergers that results in anticompetitive information conduits since efficiencies that result from an anticompetitive aspect of the merger are not cognizable in a defense

Anticompetitive information conduits

- Remedies
  - Historically
    - For most of modern antitrust history, the agencies have settled investigations involving vertical anticompetitive information conduits through consent decrees requiring that the merged firm put an information “firewall” to prevent CSI obtained from rivals through a vertical relationship to be disclosed to part of the firm that competes horizontal with those rivals
  - More recently
    - Since the end of the Trump administration, the agencies have not accepted behavioral consent decrees, so it is unlikely that the agencies will accept a “firewall consent decree to resolve an anticompetitive information conduit concern
      - WDC: While the FTC has alleged an anticompetitive information conduit theory in several vertical merger challenges, each of these cases also has involved a more significant foreclosure/RRC theory. I am not aware of any challenge to a vertical merger based solely on an information conduit theory

Vertical coordinated effects

- The competitive harm
  - The standard horizontal coordinated effect theory applies:
    1. The market must be susceptible to coordinated interaction premerger
    2. The merger must increase the likelihood, effectiveness, or stability of coordinated interaction
  - Observations
    - Looks to coordinated interaction at the horizontal level
    - The second element requires a causal relationship between the merger and the increased probability or effectiveness of tacit coordination
    - A vertical merger may increase the likelihood, effectiveness, or stability of coordinated interaction in number of ways. For example, the merger may—
      1. Eliminate a maverick/reduces the incentive of a merging firm to be a maverick at the horizonal level
      2. Eliminate a disruptive buyer at the vertical level
      3. Provide the merged firm with access to the competitively sensitive information of its rivals through its vertical relationship may facilitate reaching a tacit agreement or detecting deviations at the horizontal level
         - This is especially true if some other major firms in the market are similarly vertically integrated
      4. Increase the merged firm's ability to "punish" deviations from tacit coordination by restricting the deviator's access to the critical input or output
      5. Raise barriers to entry, thereby reducing the likelihood of external interference from new entrants
      6. (Maybe) Create increased homogeneity at the horizontal level and thereby better align incentives to tacitly coordinate

Vertical coordinated effects

- Defenses
  - Same as with horizontal coordinated effects
- Remedies
  - Same as with horizontal coordinated effects