The 2024 Merger Guidelines: A Giant Leap in the Wrong Direction

Dan O'Brien
Microfoundations
Compass Lexecon

This presentation provides an assessment of the New Merger Guidelines based on the economic literature. The views expressed herein are my own and do not purport to represent the views of Compass Lexecon.

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Overview

- Major changes in the Merger Guidelines
- Errors that harm the analysis of all types of mergers
- Issues with Specific Guidelines
  - Horizontal mergers
  - Vertical and conglomerate complements mergers
  - Dominance
  - Incipiency, trends toward consolidation
  - Platforms
  - Buyer power
- Conclusion

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Disclaimer

- This will be a highly critical review. Not much I like about the new Guidelines, and I will be brutally honest about that
- The New Guidelines have so many problems that it is difficult to discuss them in an organized way. I'll do my best
- These are obviously my own opinions
- You may disagree with my opinions. If so, my challenge to you is to provide an economic basis for your disagreement

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Major Changes in the New Guidelines

- New Format
  - Series of specific "Guidelines" numbered 1-11
    - How mergers can harm competition (1-6)
    - Evidence Agencies will examine (1-6 and 7-11) to evaluate mergers
  - Shift from starting with market definition is a welcome change
  - Relegation of most economics to an appendix gives wrong signal
    - Especially given the expansion to to non-horizontal concerns
- Addition of non-horizontal mergers
  - In principle, a welcome addition, but:
- Erroneous assertions about what competition does and does not do
- Adoption of unworkable and in my view highly mis-guided prima-facie/ burden-shifting approach for all mergers (horizontal and non-horizontal)
- Relegation of first-order effects to rebuttal evidence – ***terrible*** choice
- Increased emphasis on share/concentration for horizontal mergers; extension of that approach to non-horizontal merger analysis contrary to implications of economic literature

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Errors That Harm Analysis of All Mergers

Erroneous description of effects of competition

- The Overview starts on the wrong foot by asserting that competition ***does*** things it does not necessarily do:
  - "Competition is a process of rivalry that incentivizes businesses to offer lower prices, improve wages and working conditions, enhance quality and resiliency, innovate, and expand choice, among many other benefits. Mergers that substantially lessen competition or tend to create a monopoly increase, extend, or entrench market power and deprive the public of these benefits." (New Guidelines, p. 1.)
- This is a mistake
  - Competition incentivizes lower prices? Depends
  - Competition improves wages and working conditions? Depends
  - Competition incentivizes enhanced qualtiy? Depends
  - Competition incentivizes innovation? Depends
  - Competition incentives expanded choice? Depends

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Errors That Harm Analysis of All Mergers
Erroneous description of effects of competition

- Unfair? ***No***. Language is ***wrong***, and will lead lawyers and policy-makers with little or no background in economics down wrong paths
- Compare with the 2010 Guidelines Overview statement:
  - "The unifying theme of these Guidelines is that mergers should not be permitted to create, enhance, or entrench market power or to facilitate its exercise. For simplicity of exposition, these Guidelines generally refer to all of these effects as enhancing market power. ***A merger enhances market power if it is likely to encourage one or more firms to raise price, reduce output, diminish innovation, or otherwise harm customers as a result of diminished competitive constraints or incentives.***" (2010 Guidelines, p. 2.)
- The 2010 Guidelines were very careful to avoid saying competition ***does*** things that it may or may not do
- Instead, the 2010 Guidelines said that mergers that raise price, reduce output, diminish innovation or otherwise harm customers ***as a result of diminished competitive constraints or incentives*** should not be permitted

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Errors That Harm Analysis of All Mergers
Failure to distinguish substitutes & complements

- Remarkably, the New Guidelines:
  - Do not use the word ***horizontal***;
  - Use the words ***vertical*** and ***complements*** only when discussing competitive harms or rebuttal claims;
  - Do not reference the case of ***independent products*** unrelated in demand
- Failure to reference these terms in new Guidelines that add non-horizontal concerns is an incredible omission
- The reason is that foundational economics regarding the effects of mergers are embodied in these terms
- Consider the following simple pre-merger model:

$$Firm\ 1\colon \max_{p_1} (p_1 - c)D_1(p_1, p_2)$$
$$Firm\ 2\colon \max_{p_2} (p_2 - c)D_2(p_1, p_2)$$

- If firms 1 and 2 merge, is this a horizontal merger? Complements merger? Independent products merger? Does it matter? Why or why not?

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Errors That Harm Analysis of All Mergers
Failure to distinguish substitutes & complements

- Formally, the New Guidelines avoid distinguishing mergers by the sign of the cross partials of demand, which could be positive (substitutes, thus horizontal), negative (thus complements), or zero (thus independent products)
- Writing Guidelines in a way that suggests these distinctions matter little is a ***huge mistake***
- To be sure:
    - There can be aspects of combining complements in horizontal mergers and combining substitutes in complements mergers.
    - That does not mean the merger guidelines should relegate incentive effects that depend on the substitutes/complements distinction to the annals of history. Doing so is ***unscientific in the extreme***
    - We will see the confusion and mis-conceptions this causes in the platform discussion, where these basic distinctions remain ***the*** driving forces behind merger effects irrespective of use of the term "platform."

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Errors That Harm Analysis of All Mergers
Prima-facie burden-shifting approach for all mergers?

- The New Guidelines attempt to apply a prima facie/burden-shifting approach to non-horizontal mergers:

> "When companies propose a merger that raises concerns under one or more Guidelines, the Agencies closely examine the evidence to determine if the facts are sufficient to infer that the effect of the merger may be to substantially lessen competition or to tend to create a monopoly (sometimes referred to as a ***"prima facie case"***).
>
> …
>
> Specifically, Guidelines 1-6 describe distinct frameworks the Agencies use to identify that a merger raises ***prima facie concerns***, and Guidelines 7-11 explain how to apply those frameworks in several specific settings.
>
> …
>
> [T]he ***Agencies will also examine relevant evidence to determine if it disproves or rebuts the prima facie case*** and shows that the merger does not in fact threaten to substantially lessen competition or tend to create a monopoly." (2023 Merger Guidelines, p. 2)

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Errors That Harm Analysis of All Mergers
Prima-facie burden-shifting approach for all mergers?

- To make sure we are square on terms, we have from Blacks Law Dictionary:

  Prima Facie -- “At first sight; on the first appearance; on the face of it; so far as can be judged from the first disclosure.” A “prima facie case” is one “[s]uch as will prevail until contradicted and overcome by other evidence … [a] case which has proceeded upon sufficient proof to that stage where it will support finding if evidence to the contrary is disregarded.”

- **Problem**: This approach ***does not work*** for assessing mergers where
  - (a) economic theory and empirical evidence do not indicate a reasonably strong presumption of harm;
  - (b) the merger generates first-order benefits that interact with potential harms in ways that affect whether *any* harms are likely; and
  - (c) no analysis of these benefits conducted independently of the analysis of harms can establish whether the merger has net procompetitive or anticompetitive effects

  Each of points (a)-(c) is true for most non-horizontal mergers

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Errors That Harm Analysis of All Mergers
Prima-facie burden-shifting approach for all mergers?

Examples showing why the approach fails

- Complements mergers (vertical and conglomerate)
  - First order benefits that interact with potential harms to determine the outcome are relegated to rebuttal evidence
  - But separate analysis of benefits and harms cannot reach a conclusion
  - There can be no prima-facie case without accounting for both effects
- Mergers involving innovators
  - Mergers involving new innovators are not purely horizontal mergers
  - They often occur in innovation markets where developers intend to sell to others better at sales and marketing
  - Complementarities between innovators and acquirers, which are relegated to rebuttal evidence, need to be incorporated into the analysis

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Errors That Harm Analysis of All Mergers
Prima-facie burden-shifting approach for all mergers?

Examples showing why the approach fails

- Tying/Bundling
  - Prima facie case must show post-merger tying/bundling likely and harmful
  - Tying/bundling is often beneficial. Empirical work shows full-line forcing increased welfare in videos. Theory shows tying/bundling often expands output
- Dominance
  - Mergers by firms deemed dominant that increase quality, enhance investment, mitigate double marginalization, lower transaction costs, etc., increase a firm's "dominance" as measured by its market share while benefitting consumers
  - In the implicit benefit-cost calculus behind the net effects of non-horizontal mergers, the first-order benefit side of the ledger often increases with the merging firms' shares and thus with share-based measures of dominance
  - Benefits and harms interact and can't be analyzed separately

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Issues with Specific Guidelines
Horizontal Mergers

<u>Tighter safe-harbor threshold for ”horizontal” mergers</u>

- The New Guidelines tighten the share thresholds in two ways:
  - Merger presumed harmful if HHI > 1800 and delta HHI > 100
  - Merger presumed harmful if merged firm’s share exceeds 30% and delta HHI > 100
- Agencies presumably believe previous thresholds were too permissive
  - Formal interpretation would be that presumed default efficiencies were too high. (See Nolke & Whinston, AER, 2022)

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- Another likely motivation: Desire to stop acquisitions of nascent and potential competitors
- But should a merger between a firm with a 30% share and one with 1.67% share be presumptively illegal?
- As noted earlier, nascent acquisitions often are not purely horizontal
  - Innovation markets example

Issues with Specific Guidelines
Vertical and conglomerate mergers

Mis-classification of first-order benefits

- Complements mergers have pro-competitive first-order effects
  - By first-order effects, I mean incentive effects caused directly by the change in ownership and control (sometimes called “direct” effects)
- The New Guidelines relegate these first-order effects to rebuttal evidence. Why?
- Classifying first-order benefits in complements mergers as rebuttal evidence is no different than classifying first-order harms from horizontal mergers to rebuttal evidence
- Classifying first-order benefits from complements mergers differently than first-order harms from horizontal mergers ***does not make any sense***
- As noted earlier, it is not possible to develop a prima facie case against complements mergers without considering first-order effects

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Specific Guidelines
Vertical and conglomerate mergers

Draconian Rebuttal Evidence Requirements

- Can errors from mis-classifying first-order benefits be recovered via rebuttal evidence? No
- Successful rebuttal has three requirements: (1) Merger Specificity, (2) Verifiability, and (3) Not "Anticompetitive"
- ***Merger Specificity*** – Makes sense, but the New Guidelines all-but-assume that contracts and information are complete, which is likely wrong
- ***Verifiability***
  - Makes sense to use "reliable methodology and evidence not dependent on the subjective predictions of the merging parties or their agents," but
  - A "reliable" method for "verifying" prospective net benefits requires modelling benefits and harms in an equilibrium framework
- ***Not "Anticompetitive"***
  - Requires that benefits must not arise from worsening of rival terms
  - But pro-competitive complements mergers can worsen rival terms and might not occur otherwise

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Specific Guidelines
Vertical and conglomerate mergers

Presumptions Inconsistent with Basic Economics

- Guideline 5 discusses the notion of "related market" and the ability of a merged firm to limit access to the the related product
- The Agencies then define the "***foreclosure share***" as the share of the related market to which the merged firm could limit access
- "**If the share or other evidence show that the merged firm is approaching or has monopoly power over the related product, and the related product is competitively significant, those factors alone are a sufficient basis to demonstrate that the dependent firms do not have adequate substitutes and the merged firm has the ability to weaken or exclude them by limiting their access to the related product**. (See Considerations 1 and 2 in Section 2.5.A.1)." (New Merger Guidelines, pp. 15-16)

BAD ECONOMICS

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Specific Guidelines
Vertical and conglomerate mergers

Presumptions Inconsistent with Basic Economics

- In many settings, ***beneficial*** effects from complements mergers—those effects relegated to rebuttal evidence in these Guidelines—***rise*** with the merging firm's related market share
- There is ***NO*** economic basis for a prima facie case against complements mergers based on share in the related market
- In fact, economic analysis shows in a textbook environment that for any given upstream and downstream unit margins, the potential harm from vertical mergers falls with the merging firm's share in the related market
  - Reason: A high related market share requires greater substitution to alternatives to rationalize the upstream/downstream margin ratio
- Policy problem: ***non-equilibrium analysis*** has led to ***bad policy***

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Specific Guidelines
Dominance

- Guideline 6 states: “Mergers Can Violate the Law When They Entrench or Extend a Dominant Position.”
- This Guideline does not qualify the statement by type of merger, so it apparently applies to all mergers in which the entrenchment or extension of “dominance” can be established
- Application of this Guideline requires a definition of “dominance,” but the New Guidelines fail to provide one
- The Guideline mentions using “direct evidence or market shares showing durable market power,” but they do not define “durable market power” or the shares that would indicate dominance
- They state: “For example, the persistence of market power can indicate that entry barriers exist, that further entrenchment may tend to create a monopoly, and that there would be substantial benefits from the emergence of new competitive constraints or disruptions.”
- This statement does not define “durable market power” or the “persistence of market power;” it simply assumes these phrases are understood

NEBULOUS GUIDANCE

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Specific Guidelines
Dominance

Barriers to Entry or Competition

- Examples involve acquisitions by firm A of firm B that supplies a complement used by one or more of firm A's rivals.
- Concerns about the potential anticompetitive effects of such mergers are largely already covered in Guideline 5
- The same criticisms apply:
  - Because first-order benefits from complements mergers typically increase with the degree of pre-merger market power as measured by share, measures of "dominance" related to share cannot provide a basis for stopping such mergers
  - Relegating first-order benefits from complements mergers to rebuttal evidence, which Guideline 6 does, makes it all but impossible for other evidence to establish a prima facie case because benefits and harms interact to determine equilibrium effects, which means that ignoring first-order benefits leads to incorrect answers about foreclosure effects

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Specific Guidelines
Dominance

Diagonal Mergers (A phrase I would have included)

- I wish the New Guidelines retained this concept from the VMGs
- Suppose B is an input into production used by A's rivals but not used by A
  - A merger between A and B is "diagonal" as described in the VMGs
- Purely diagonal mergers are more like horizontal mergers than complements mergers
- In the special case where A is integrated and supplies the input to itself internally both before and after the merger, the merger is literally a horizontal merger that combines A's integrated input with competing input B
- It may be appropriate to treat purely diagonal mergers—where the acquisition has no effect on the acquired firm's marginal cost—more like horizontal mergers
- The same type of argument holds if product B and the rival's product are complementary components purchased and assembled by customers rather than sold in a vertical relationship and produced/assembled and resold to customers

Specific Guidelines
Dominance

<u>Nebulous Nascent Competition Concern</u>

- Guideline 6 also raises concern with mergers that could entrench or extend a dominant position by eliminating a nascent competitive threat
  - E.g., a merger of dominant firm A and nascent threat B where B could become an important input or complement to a rival
- The analysis of this issue is conceptually the same as the analysis of mergers generally, the only difference being that B is "nascent."
- The effect of such an acquisition depends on whether the merger combines complements, is purely diagonal, or is horizontal, and the amount of competition lost – like any merger
- All of the criticisms made in the preceding slide hold
- The "nascency" of B makes it critical to establish not only the nature of the relationship between A and B, but also B's future competitive significance. Obviously, this adds an additional layer of speculation

Specific Guidelines
Dominance

<u>Nebulous Tying/Bundling Concerns</u>

- Guideline 6 also worries that "the merger might lead the merged firm to leverage its position by tying, bundling, conditioning, or otherwise linking sales of two products," which for simplicity I will refer to as "bundling"
- As with the concern about nascent competitive threats, concerns about bundling involve two levels of speculation: (i) that the merged firm will bundle; and (ii) that this will harm competition
- Bundling has theoretically ambiguous effects
- The notion that a prima facie case could be made based on concerns about post-merger bundling is not supported by the economic literature
  - There is no a priori reason to believe that if bundling did occur it would be anticompetitive

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Specific Guidelines
Incipiency, trends toward consolidation

- Guideline 7 states: "When an Industry Undergoes a Trend Toward Consolidation, the Agencies Consider Whether It increases the Risk a Merger May Substantially Lessen Competition or Tend to Create a Monopoly."
- Guideline apparently applies to all mergers
- References the Supreme Court: "a trend toward concentration in an industry, whatever its causes, is a highly relevant factor in deciding how substantial the anticompetitive effect of a merger may be."

...

- Supreme Court statement is from a 1966 decision before the first Merger Guidelines were adopted in 1968.
  - Those Guidelines, and each revision, recognize the relevance of a trend toward concentration in the level of concentration in the relevant market
- It is unclear what is gained by highlighting a trend already embodied in the current market structure

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Specific Guidelines
Platforms

- Guideline 9 discusses multi-sided platforms
- Decision to add this Guideline highlights the cost of failing to distinguish horizontal, vertical/complements, and independent product effects.
  - All the issues raised by mergers that involve platforms or competitors on one or the other sides of platforms boil down to horizontal and vertical/complements issues, often an amalgam of the two
  - The discussion of platforms and the burgeoning literature around them makes it appear as if the antitrust issues are somehow different than before, but at a high level, they are not

Specific Guidelines
Platforms

- Platforms Guideline discusses competition between and on platforms
- Examples of potentially harmful mergers include:
  - (A) mergers between platforms (horizontal);
  - (B) acquisition of a platform participant by a platform operator (vertical/complements or diagonal, as the components or services provided by platform participants are complementary to the service provided by the platform operator);
  - (C) acquisitions of platform participants that facilitate interoperability between platforms (vertical/complements, but nuanced, as discussed further below); and
  - (D) mergers that involve acquisitions of suppliers of other inputs to platforms (presumably by platform operators, though not specified), which might be denied to rival platforms (vertical/complements)

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- **E**xamples A, B, and D all fall into standard merger classes: horizontal, or vertical/complements
- Example A is a horizontal merger

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Specific Guidelines
Platforms

- Example C raises an issue that is specific to environments with strong network effects, which are often present on platforms:
  - (C) acquisitions of platform participants that facilitate interoperability between platforms (vertical/complements);
- The concern is the acquisition of third-parties to stop them from providing interoperability services that exploit network effects
- The objective of action against (C) is to prevent acquisitions that would limit interoperability benefits and increase a platform's market power

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- The foray of the New Guidelines into policy that affects interoperability between competitors is really a deeper foray into regulation via antitrust enforcement
- Absent regulation, firms are ordinally permitted to deal with whoever they please (Aspen Ski being the main exception)

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Specific Guidelines
Platforms

- If separate privately-owned platforms match consumers with advertisers, are they obligated to match with advertisers on the other platform?
  - If a third-party tool makes cross platform matches possible but platform A doesn't want this, it might rightly complain that the 3rd party allows rival platforms to free ride on platform A's content
- Suppose a Burger King employee set up a portable grill in a McDonalds restaurant so it could cook Whoppers and sell them to McDonalds patrons. Is this OK?
  - An obvious way for McDonalds to stop this activity is to require the operator of the Burger King grill to stay out of its stores
  - If keeping the grill out is not possible, McDonalds might instead acquire the operator and give them a job as a cook to produce McDonalds hamburgers
- Over the top analogy? I'm not sure it is. The point is that this Guideline amounts to imposing a duty to deal at some price, which is price regulation
- Is antitrust the right tool? If the issue is network effects indicate the need for regulation, maybe Congress should pass legislation regulating

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Specific Guidelines
Buyer power

- Guideline 10 focuses on input market effects. The Guideline states:
  - [A] merger's harm to competition among buyers is not saved by benefits to competition among sellers. ... [I]f input costs are expected to decrease, the cost savings will not be treated as an efficiency if they reflect an increase in monopsony power." (2023 Merger Guidelines, p. 33)
- Unfortunately, the New Guidelines do not define "monopsony," and this creates a problem.
- If "monopsony" is associated with any merger that leads to a lower input price paid for an input, then this Guideline is mis-guided.

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Specific Guidelines
Buyer power

- It is important to distinguish two pricing institutions
  - Classic monopsony (“supply-price institution”) and
  - Demand price institutions

  The effects of buyer power depend on which institution is relevant
- In demand price settings, a lower input price lowers the purchasing firm’s marginal cost in the output market and benefits final consumers.
  - Majority of the economic literature on vertical contracting
- In classic monopsony, a lower input price may discourage input supply and cause monopsony effects that harm suppliers and final consumers

...

- It is unclear whether the Agencies label countervailing power that lowers input prices and expands output as monopsony (it’s not)
- Previous Guidelines appropriately recognized monopsony and countervailing power effects (demand price institutions) as possibilities
- The New Guidelines are unclear but can be read to suggest that lower input prices due to countervailing buyer power are anticompetitive

Conclusion

The New Guidelines swung and missed

I give them credit for swinging, but the drafters need more batting practice and then should go back to the plate and try again