What's Gone Up Is Coming Down? Vertical Mergers in the 2023 DOJ-FTC Draft Merger Guidelines, Comment of the Global Antitrust Institute

Alexander Raskovich, Antonin Scalia Law School, George Mason University

Bruce H. Kobayashi, Antonin Scalia Law School, George Mason University

Abbott B. Lipsky, Jr., Antonin Scalia Law School, George Mason University

John M. Yun, Antonin Scalia Law School, George Mason University

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VERTICAL MERGERS IN THE 2023 DOJ-FTC DRAFT MERGER GUIDELINES, COMMENT OF THE GLOBAL ANTITRUST INSTITUTE

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The Global Antitrust Institute ("GAI") submits this comment to the U.S. Department of Justice ("DOJ") and Federal Trade Commission ("FTC") on the Agencies' draft Merger Guidelines ("DMGs"),[1] which are intended to replace both the 2010 Horizontal Merger Guidelines ("2010 HMGs") and the 2020 Vertical Merger Guidelines ("2020 VMGs"). This comment, which focuses on Sections II.5 and II.6 of the DMGs (discussing vertical and complementary mergers), is based on the GAI's extensive experience and expertise in competition law and economics.[2]

Combining the treatment of horizontal and vertical mergers into a single set of guidelines can be rationalized by economies of scope in presentation, given that the two merger types share several analytic elements in common. The 2020 VMGs incorporate by reference the sections in the 2010 HMGs regarding the sources of evidence on which the Agencies generally rely,[3] methodologies for defining markets[4] and for measuring market shares,[5] relevant evidence for customer switching[6] and for a market's vulnerability to

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[1] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, MERGER GUIDELINES (2023), https://www.justice.gov/d9/2023-07/2023-draft-merger-guidelines_0.pdf.

[2] The GAI is a division of George Mason University's Antonin Scalia Law School and reports to the Dean of the Law School. In support of its mission, the GAI draws upon the independent expertise of the Law School faculty including Bruce H. Kobayashi, Paige V. and Henry N. Butler Chair in Law & Economics and former Director of the Bureau of Economics, FTC; Abbott B. Lipsky, Jr., Adjunct Professor, Director of Competition Advocacy for the GAI, former Acting Director of the Bureau of Competition, FTC, and former Deputy Assistant Attorney General for Antitrust, U.S. Department of Justice; Dr. Alexander Raskovich, the GAI's Director of Research; and John M. Yun, Associate Professor and former Acting Deputy Assistant Director, Bureau of Economics, FTC. We thank Sarah Kratt for excellent research assistance. The GAI is grateful for the generous contributions from the individuals, foundations, and corporations that enable the GAI to carry out its mission. Its finances are managed through the George Mason University Foundation, Inc., which is a 501(c)(3) corporation established to support the activities of George Mason University. More information may be found at https://gai.gmu.edu.

[3] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, VERTICAL MERGER GUIDELINES 3 (2020), https://www.justice.gov/media/1090651/dl?inline.

[4] *Id.*

[5] *Id.* at 4.

[6] *Id.* at 5.

coordination,[7] and the evaluation of efficiencies.[8]

The DMGs do not merely consolidate the texts of previous guidelines, however, but in Section II.6 advance a thesis that vertical mergers are fundamentally similar to horizontal mergers and should be treated as such, with structural presumptions for harm and a competitive effects equivalence between horizontal mergers that tend toward monopoly and market-wide trends toward vertical integration. This is gross error. Vertical mergers differ fundamentally from horizontal mergers and their proper analysis should reflect these differences.

If the animating rationale behind Section II.6 is to facilitate the blocking of more vertical mergers by lowering the evidentiary bar for finding harm, the DMGs fail on this score. Changes to Agency guidelines do not induce judicial compliance with those changes. It works the other way round, of course: courts tend to be persuaded by guidelines' arguments that reflect common-sense, well-founded economic analysis of competitive effects. Previous merger guidelines have deeply influenced antitrust jurisprudence for this reason. But the treatment of vertical mergers in Section II.6 of the DMGs, departing sharply from the 2020 VMGs, undermines its power to persuade by omitting virtually all economic analysis of competitive effects. Nor is Section II.6 strengthened by its attempted grounding in the text of Supreme Court case law. The DMGs' structural presumptions for vertical merger are not supported by this case law, which focuses on competitive effects over market structure.

Strangely, Section II.6 of the DMGs is preceded by Section II.5, which covers similar ground to Section II.6 but is consistent with the economic analysis of vertical and complementary goods mergers in the 2020 VMGs. Sections II.5 and II.6 thus stand in stark mutual contradiction. We urge the Agencies to expand on the economic insights in Section II.5 of the DMGs—in particular, to introduce a discussion of the prospective elimination of double-marginalization ("EDM") by vertical merger—and to discard Section II.6 entirely. The economic insights that went up with the 2020 VMGs should not be brought down by the misguided structural treatment of vertical mergers in Section II.6 of the DMGs.

The remainder of this comment is organized as follows. Sections 1, 2, and 3 discuss

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[7] *Id*. at 10.

[8] *Id*. at 11.

the fundamental differences between horizontal and vertical mergers through the lens of the economic theory of the firm and the alternative of organizing transactions through incomplete contracting at arm's length. Section 4 explains why the presumption of harm based on market share in Section II.6 of the DMGs is inappropriate for analyzing vertical mergers. The presumption is not supported by either economic analysis or legal precedent. In our Section 5, we discuss the "plus factors" in Section II.6 for evaluating mergers that do not trigger these presumptions. These are untethered from economic realities, in stark contrast to the economic analysis in Section II.5 of the DMGs. Our Section 6 summarizes our conclusions and recommendations.

1. Theory of the Firm

The spur to any merger, whether horizontal or vertical, is an anticipated improvement in coordination between the merging parties, insofar as this raises the merging parties' joint profits over the alternatives to integration. Improved coordination frequently also serves to sharpen competition with non-merging market participants, thereby enhancing market efficiency. Assessing the likely effects of a given merger requires an understanding of the contractual alternatives to integration the merging parties face.

Nobel Laureate economist Ronald Coase, in his seminal study of the nature of the firm,[9] was the first to address integration issues in the economics literature. Coase posed the fundamental question of why some economic activities are organized within firms while others are transacted across markets. In principle, economic activity is organized within a firm when doing so would entail lower transaction costs (or higher joint profit) than would a market transaction. Firm boundaries are determined by the scope of economic activity that, by being withdrawn from the market and organized within the firm, maximizes the parties' joint profit.[10]

For transactions conducted at arm's length across a market, contractual incompleteness poses a key impediment to joint profit maximization.[11] Contracts are

[9] *See generally* Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

[10] Costs of organizing activity within a firm include diseconomies of scope in managerial control: the quality of managerial oversight can decline as the scope of that oversight expands.

[11] *See* Coase, *supra* note 9, at 390-391. Among other factors, Coase discusses the costs of discovering market prices and negotiating repeatedly when transactions are at arm's length. For evidence on how costs of price

typically incomplete in part because it would be prohibitively costly to enumerate the parties' appropriate rights and obligations in every conceivable contingency. Moreover, some important features of the parties' economic relationship, even if those features could be enumerated, may not be amenable to verification by a third party, such as a court or arbitrator, and so may not be contractually enforceable.

2. Imperfect Coordination

Contractual incompleteness can give rise to coordination problems between the parties dealing at arm's length. When coordination is imperfect, neither party fully takes into account the effects that its actions have on the other party's profit. The policy implications of imperfect coordination can differ sharply, however, according to whether the coordination involves goods that are substitutes or complements.

2.1 Horizontal Coordination

Horizontal relationships involve *substitute* goods. Two goods are substitutes if a change that increases the quantity demanded of one, such as a reduction in the good's price or an improvement in its quality, leads to a fall in demand for the other. Imperfect coordination between suppliers of substitute goods implies that neither party fully internalizes the adverse effect that a reduction in its price or improvement in its quality has on the other party's profit. Better coordination might thus lead the merged firm to increase joint profits by, for example, raising price or reducing quality to economize on cost.

Lack of coordination between suppliers of substitute goods is an essential aspect of competition. While uncoordinated behavior depresses the horizontal merging parties' joint profits, it can increase overall efficiency, by spurring the parties to lower price and improve quality as each seeks to steal business from the other. This externality between the parties could be better internalized by their horizontal merger, which would tend to raise the parties' joint profits but could also lessen efficiency and result in poorer outcomes for consumers.

The basic economic intuition that improved coordination between substitute goods,

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determination affect contracts, *see* Francine Lafontaine & Scott E. Masten, *Contracting in the Absence of Specific Investments and Moral Hazard: Understanding Carrier-Driver Relations in U.S. Trucking*, NBER WORKING PAPER 8859 (2002). For evidence on how costs of repeated negotiation affect contracts, *see* Keith J. Crocker & Scott E. Masten, *Pretia ex Machina? Prices and Process in Long Term Contracts*, 34 J. L. & ECON. 64 (1991).

as through a horizontal merger, tends to lessen competition and raise price can be overturned if there are also sufficiently large efficiencies created by the merger. These include merger-specific reductions in cost that come from combining complementary assets, economizing on duplicative assets, or achieving scale economies, as well as facilitating quality improvements specific to the merger. Thus, although a horizontal merger eliminates competition between the merging parties, it can also sharpen the merged firm's competition with other market participants through the realization of efficiencies which, if sufficiently large, can result in a net increase in competition in the market.[12]

The incompleteness of contracting between horizontal parties that gives rise to coordination problems is partly by design, as a matter of public policy. For example, competitors are prohibited by antitrust law from reaching a naked agreement to fix prices, because such explicit coordination would, by definition of the term "naked," lessen competition without any countervailing prospect for generating efficiencies that might sharpen competition. Competitors are allowed to reach other types of agreement (more vertical in character), such as tolling arrangements whereby a firm with a comparative disadvantage at one stage of the production process outsources this function to a more efficient rival. Here, rule-of-reason analysis is typically invoked to assess whether the agreement stifles or promotes competition.

2.2 Vertical Coordination

Vertical and complementary relationships differ fundamentally from horizontal ones, in that they involve either complementary goods or successive stages of a vertical supply chain. Two goods are complements if a change that increases the quantity demanded of one, such as a reduction in the good's price or an improvement in its quality, leads to an increase in demand for the other. Imperfect coordination between suppliers of complementary goods implies that neither party fully internalizes the salutary effect that a reduction in its price (or improvement in its quality or other strategic competitive choices) has on the demand for the other party's good and hence its profit. In the classic complementary goods problem, each firm sets a markup above its good's marginal cost. Such "double marginalization"

[12] Increased efficiency and sharpened competition can often be viewed as two sides of a coin, or two halves of a virtuous circle. Competition drives firms to seek cost-reducing or quality-enhancing efficiencies so as to win sales from rivals; attaining greater efficiency drives competition with rivals to win sales.

results in prices that are too high—both firms could earn higher profit by pricing somewhat lower, and consumers of the complementary goods would also benefit. When pre-merger coordination is imperfect in this way, a merger between the firms would tend to eliminate double-marginalization ("EDM"), lowering the complements' prices to the benefit of both the merged firm and consumers.

Likewise, separate firms operating at successive levels of a supply chain may each fail to fully internalize the effects of their competitive actions on the other. For example, a manufacturer and retailer may each set a markup resulting in a double-marginalization problem, a high retail price that reduces the quantity demanded by final consumers. In this case, a vertical merger between the firms would tend to result in EDM, raising the merged firms' joint profits and benefiting consumers as well.

Improved coordination between suppliers of complementary goods and between firms operating at successive stages of a vertical supply chain is thus an essential aspect of efficiency and therefore of competition. A vertically integrated firm's enhanced ability to compete with rivals at either stage in the supply chain, due to its improved coordination of price and non-price actions, tends to intensify competition in both vertically related markets.

Such improved coordination raises the parties' joint profits and tends to increase overall market efficiency through lower prices or improved quality. The externality between the parties dealing at arm's length could be better internalized by their vertical merger, which would tend to result in lower prices or a higher level of quality or quickened pace of quality improvement. These salutary effects flow from the intensified competition the vertical merger tends to engender.

Although EDM in its classic form refers to a post-merger reduction in prices below pre-merger levels, the EDM concept is not limited in principle to price effects. More broadly, EDM encompasses any salutary effect on competition that flows from an improvement in coordination between the merging parties in their strategic choices. The post-merger improvement could manifest as an increase in product quality, a decrease in delivery times, a faster pace of innovation, and the like.

Just as an economic analysis that predicts a horizontal merger would likely increase the merging parties' power to raise price does not imply that the anticompetitive effect would in fact manifest as a price increase—it could be an anticompetitive degradation in quality of the product, delivery or service, a slackening of innovation, etc. Conversely, an EDM effect in a vertical merger could take the form of improvements in non-price dimensions rather than a reduction in price.

2.2.1 Vertical Coordination to Foreclose Rivals

Vertical mergers can sometimes blunt competition, but only indirectly through a horizontal effect. For example, the downstream merging party would tend to gain by having the marginal costs of its rivals raised, say through higher input prices, thereby lessening the competition rivals pose to its own expansion of output. This might be achieved by having the upstream merging party raise its input prices to those downstream rivals of the merged firm, by bidding less aggressively to serve them,[13] or denying or degrading rivals' access to the merged firm's inputs.[14]

Although such strategies[15] would tend to raise the downstream merging firm's profit, they would also tend to lower the upstream merging firm's profit. This is because the upstream merging firm had been acting to maximize its own profit pre-merger; thus any deviation from pre-merger actions would tend to lower its profits post-merger. A post-merger foreclosure strategy (whether partial or full) would only be profitable to the merged firm if the resulting gains downstream outweigh the losses upstream.[16] This goes to the important discussion of incentives to foreclose in Section II.5 of the DMGs, which is wholly absent from the succeeding Section II.6.

3. Two Fundamental Differences between Horizontal and Vertical Mergers

To sum up the discussion of imperfect coordination in Section 2, it is important to note that vertical mergers (as well as mergers of complementary goods) differ from horizontal

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[13] On the latter point, *see* Joseph Podwol & Alexander Raskovich, *Analyzing Vertical Mergers with Auctions Upstream*, ECON. ANALYSIS GROUP DISCUSSION PAPER 21-14, https://papers.ssrn.com/abstract_id=4125504.

[14] A refusal to deal with rivals is insufficient for a finding of foreclosure; rivals must be found to lack viable alternative sources of supply. A symmetric concern is that denying or degrading access to customers through actions of the downstream merging firm may substantially lessen competition in the upstream market.

[15] The seminal work on raising rivals' costs is Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209 (1986).

[16] A necessary (but not sufficient) condition for harm to arise from a vertical merger is that a foreclosure strategy be profitable to the merged firm.

mergers in two fundamental respects.

First, a purely vertical merger does not have the effect of eliminating competition between the merging parties, which is inherent to horizontal merger. Improvement in coordination between vertically merging parties inherently enhances efficiency, which in turn tends to increase competition at both levels of the supply chain.

Second, and relatedly, the post-merger enhancements in efficiency inherent to improved vertical coordination fall into a quantitatively identifiable category commonly labeled EDM—which may manifest as reductions in price or as improvements in non-price dimensions such as quality that redound to consumers' benefit.

The proper antitrust analysis of vertical (and complementary goods) mergers should recognize that EDM is a *procompetitive effect*, not an efficiency in the technical antitrust sense. The difference between the two is whether the effect is intrinsic or extrinsic to the merger being analyzed. In modeling terminology, EDM is *endogenous* to the merger analysis; it is inherent to the changed incentives that the merger brings about. Precisely the same post-merger change in incentives that may result in some degree of foreclosure, e.g., by the upstream merging firm raising input prices to the downstream merging firm's rivals, also tends to result in EDM, e.g., by reducing the internal transfer price of the upstream merging firm's input to the downstream merging firm. The former change in incentives tends to lessen downstream competition, whereas the latter change tends to increase that competition. The net of the two countervailing effects is what matters to predicting whether the merger lessens competition.

Nor would it make sense as a general matter to analyze the potential for foreclosure and EDM separately, as if these were distinct issues rather than being joined at the hip. If, for example, there were no pre-merger coordination problem involving prices, e.g., if input pricing in the industry were to take the form of two-part tariffs, then no EDM effect would likely result from the merger, but by the same token the merging parties would have no incentive to raise rival's marginal costs post-merger.[17]

[17] Downstream rivals might then pay higher lump-sum fees post-merger, but with no immediate effect on downstream prices or consumer welfare. Higher lump-sum fees might have adverse competitive effects in the longer run if, say, they were to impede rivals' ability to undertake innovative investments. This contingency would require further analysis, however. If the merging parties use two-part tariffs pre-merger but otherwise

Gloria Sheu and Charles Taragin simulate the competitive effects of vertical mergers within a rigorous economic model that naturally incorporates the interconnected nature of foreclosure and EDM effects.[18] Among their conclusions:

> [F]or vertical mergers, we show that the relative bargaining power of upstream firms compared to downstream firms has the ability to predict whether consumers are likely to be harmed from a merger, whereas the number of firms and the Herfindahl–Hirschman Index (HHI) do not. . . . We find that when upstream and downstream firms have equal [bargaining] power, the impact of vertical mergers on consumer welfare is roughly neutral.[19]

Here "bargaining power" is not market power, but rather refers to the negotiating parties' relative bargaining skill, patience, or risk tolerance, which determine how the joint gains from their merger are split between them. The relevance of bargaining power to merger outcomes thus arises from the feature of the simulation model that input prices are reached through bargaining rather than some other process. It should not come as much of a surprise that the number of market participants and market concentration are not informative about vertical merger outcomes. This result flows from the close connection between foreclosure and EDM—that the two effects are both inherent to vertical merger and are countervailing. This feature, common to most models of vertical merger,[20] underscores the wrong-headedness of the market-share threshold for harm presented in Section II.6 of the DMGs.

To complete our discussion of the contrast between vertical and horizontal mergers, we note that there is nothing in the analysis of horizontal mergers comparable to the inherent (endogenous) EDM effects of vertical merger. Although horizontal mergers can generate efficiencies, efficiency claims are (in modeling terminology) *exogenous* to standard horizontal merger analyses, requiring separate consideration and evidence. Vertical mergers can also generate efficiencies, *in addition to* their procompetitive EDM effects, and claims of exogenous efficiencies in vertical merger likewise require separate consideration.

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the industry norm is linear input pricing, there could be a foreclosure effect without an EDM effect. Again, this would require further analysis to explain whether and why the merging parties are special in this sense.

[18] Gloria Sheu & Charles Taragin, *Simulating Mergers in a Vertical Supply Chain with Bargaining*, 52 RAND J. ECON. 596 (2021).

[19] *Id*. at 598.

[20] It holds, for example, in the vertical merger simulation model of Podwol & Raskovich, *supra* note 13, where input prices are the outcome of second-price auctions rather than bargaining.

The DMGs do a good job of describing how the Agencies properly assess efficiency claims. EDM is not an efficiency, however, but an important procompetitive effect of vertical merger, and there is no mention of EDM in the DMGs. This is a serious shortcoming. We once again urge the Agencies to add a discussion of EDM to Section II.5 of the DMGs, taking proper account of the interconnectedness of post-merger incentive changes toward foreclosure and EDM. These two countervailing incentive effects are equally important to assessing a vertical merger's net effect on competition in the relevant market.

4. Presumptions Based on Market Shares Are Not Based on Market Realities

In this Section, we further detail the errors in Section II.6 of the DMGs: applying market share thresholds for presumptions of vertical merger harm and treating vertical mergers as similar to horizontal mergers.

In contrast to horizontal mergers, vertical mergers have no direct effect on market shares or concentration at either level of the merging parties' supply chain. A vertical merger thus cannot in principle lessen competition by increasing concentration. In a horizontal merger, of course, a post-merger increase in concentration does not necessarily imply a lessening of competition, but, in any case, there can be no such effect in a vertical merger.

4.1 "Foreclosure Share"

Section II.6 of the DMGs specifies a 50 percent share threshold in a related product market (e.g., an upstream input market) for a presumption of harm from vertical merger:

> The "foreclosure share" is the share of the related market that is controlled by the merged firm, such that it could foreclose [a] rival's access to the related product on competitive terms. If the foreclosure share is above 50 percent, that factor alone is a sufficient basis to conclude that the effect of the merger may be to substantially lessen competition, subject to any rebuttal evidence[.][21]

[21] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, *supra* note 1, at 17.

The phrase "could foreclose [a] rival's access to the related product on competitive terms" might appear to refer to the discussion in Section II.5 of the DMGs regarding the merged firm's *ability* to foreclose rivals. This interpretation appears to be incorrect, however, given the statement in Section II.5 that "[t]he inquiry in Guideline 6 into vertical market structures is distinct from this ability and incentive analysis."[22]

4.1.1 Economic Analysis Does Not Support a Presumption Threshold

It is incorrect as a matter of economics to infer, simply from a merged firm's high market share in the related market, an ability by the merged firm to "foreclose [a] rival's access to the related product on competitive terms." Consider the case of an upstream merging firm with high input market share by virtue of having lower marginal cost than its rivals, the rivals constituting a competitive fringe of firms that price at their common marginal cost. Pre-merger, the upstream merging firm prices at its rivals' marginal cost, and the same is true post-merger.[23] Thus, in this example the upstream merging firm's share of the related market, no matter how high (so long as it is less than 100 percent), reflects no ability to foreclose downstream rivals of the merged firm.

Moreover, the changed incentives induced by vertical merger may tend to be more salutary the larger the merged firm's share in the related market. First, the larger is the merged firm's share of the related market, the broader the merger's procompetitive EDM effect of sharpening competition and lowering prices in the relevant market may tend to be.

Second, the merged firm's monetary losses in the related market from undertaking a foreclosure strategy would tend to be greater the larger the merged firm's share in that market is. Thus, all else equal, foreclosure in the relevant market is less likely to be profitable to the merged firm the higher is the merged firm's share in the related market.

4.1.2 Legal Precedent Does Not Support a Presumption Threshold

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[22] *Id*. at 14 n.47.

[23] In this example, the upstream merging firm's marginal cost is increasing in input quantity, whereas the competitive fringe has common, constant marginal cost and has sufficient capacity to respond adequately to any input price increase by the merging firm. In equilibrium, the dominant firm's input production is determined by the point at which the dominant firm's marginal cost just equals that of the competitive fringe.

The Agencies may view Sections II.5 and II.6 of the DMGs as complementing each other rather than being mutually contradictory, that Section II.5 is grounded in economic analysis while Section II.6 is grounded in Supreme Court case law. Such a view is untenable, however. The main legal precedent to which Section II.6 refers is *Brown Shoe Co. v. United States*[24], which provides no support for Section II.6's market-share threshold. *Brown Shoe* points rather to the critical importance of an economic analysis of competitive effects.

The *Brown Shoe* court concluded that a merged firm's ability to foreclose could be inferred from its having a monopoly share (in the related market), whereas at the opposite extreme of *de minimis* share, the merged firm could be inferred to lack an ability to foreclose.[25] For intermediate cases between these two polar extremes, the court found that

> the percentage of the market foreclosed by the vertical arrangement cannot itself be decisive. In such cases, it becomes necessary to undertake an examination of various economic and historical factors in order to determine whether the arrangement under review is of the type Congress sought to proscribe.[26]

By "percentage of the market foreclosed by the vertical arrangement," the Supreme Court simply meant the merged firm's share of the related market (using the modern "related" terminology). Section II.6 of the DMGs thus employs "foreclosure share" in a manner consistent with *Brown Shoe*. But Section II.6 runs afoul of *Brown Shoe* in missing the key point that market share "cannot be decisive" in determining harm in intermediate cases. *Brown Shoe* stands for the principle that an examination of economic factors is *necessary* to assessing the merged firm's ability to foreclose when its share of the related market is above a *de minimis* level but falls short of outright monopoly.

If anything, adherence to *Brown Shoe* would have the Agencies modify the DMGs to include a safe harbor for vertical mergers in which the merged firm's share of the related market is *de minimis*.

Consistent with *Brown Shoe*'s emphasis on economic analysis of competitive effects over structural factors in evaluating vertical mergers, the D.C. Circuit in *AT&T* stated that

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[24] 370 U.S. 294 (1962).

[25] *Id.* at 329.

[26] *Id.*

> unlike horizontal mergers, the government cannot use a short cut to establish a presumption of anticompetitive effect through statistics about the change in market concentration, because vertical mergers produce no immediate change in the relevant market share. Instead, the government must make a "fact-specific" showing that the proposed merger is "likely to be anticompetitive."[27]

4.1.3 Opportunities to Rebut the Presumption of Harm Are Unreasonably Limited

In Section IV, the DMGs describe "other pertinent factors" that may rebut a presumption of merger harm. The listed factors are failing firm, entry and repositioning, and efficiencies. Section IV is written as if this list is exhaustive in the Agencies' view. If so, the scope of rebuttal evidence the Agencies are willing to contemplate is unreasonably narrow.

As discussed above, Section II.6's threshold for a presumption of harm in vertical mergers, based as it is on the merged firm's share of the related market, has little basis in economics. Intuitively, a larger share of the related market may be associated with a greater ability to foreclose rivals, if the merged firm were to refuse to deal with rivals in the relevant market. The connection is tenuous and incomplete at best, however.

Among the important substantive questions to be addressed in a reasonable antitrust inquiry are (1) whether a refusal to deal with rivals would be profitable to the merged firm (an incentive to foreclose), and (2) whether rivals would have reasonable alternatives to the merged firm in obtaining the related products or services (an ability to foreclose).

Issues (1) and (2) are reasonably addressed in Section II.5 of the DMGs. Above, we explained why a refusal to deal with rivals may not be profitable to the merged firm because of its resulting losses in the related market. This may be especially true when the merged firm's share of the related market is high and its share of the relevant market is comparably smaller. We also explained how the merged firm may lack any ability to foreclose rivals despite having a high share of the related market, if competition from other players in the related market is strong.

We urge the Agencies to delete Section II.6 in favor of expanding the economic analyses of Section II.5, but if the substance of Section II.6 were to remain in the DMGs, we

[27] United States v. AT&T, Inc., 916 F.3d 1029, 1032 (D.C. Cir. 2019) (internal citation omitted). Of course, vertical mergers also have no immediate impact on market share in the related market.

would urge that the scope for rebutting the presumption be expanded to include economic analyses of the type described in Section II.5 that could show the presumption is in error.

5. Minuses of the DMGs' "Plus Factors"

If a vertically merged firm has less than 50 percent share in the related market, so that the market-share threshold for presuming harm is not triggered, the DMGs' Section II.6 specifies "plus factors" that the Agencies will consider to indicate higher risk of merger harm. None of these plus factors merit inclusion in the analytic plus column, however. Untethered as they are from economic realities, the plus factors offer no reliable guidance on risks of harm. We consider each plus factor in turn below.

5.1 "Trend Toward Vertical Integration"

A trend toward vertical integration in an industry is not an indicator of heightened risk of harm unless vertical integration is itself presumed to be harmful and further its harmfulness is presumed to increase with its prevalence. But whether a vertical merger is likely to result in harm is the question being addressed. The logic of this plus factor is circular, a case of assuming a conclusion.

The economic theory of the firm discussed above indicates that, in the absence of anticompetitive considerations, the optimal contours of firms are determined by boundaries that separate economic activities more effectively conducted within a firm from transactions more effectively conducted at arm's length across a market. Technological and other changes in an industry's economic environment shift firm boundaries from time to time, and when they do, they often affect many or all firms in the industry. Typically, trends toward vertical integration—or toward vertical separation—arise naturally, on the competitive merits of adjusting to substantial change in the underlying economics of an industry.

Moreover, follow-on vertical integration can reflect an information effect. The commercial success of an initial instance of vertical integration in an industry, generating profits through EDM and the realization of efficiencies, can alert other firms in the industry of similar prospects. In this case, the resulting trend toward vertical integration would bring a wave of heightened competition to the relevant market.

If the Agencies were to apply such a plus factor, however, it could engender perverse incentives for firms to "race to the Agency door" to get their vertical deals through before an industry trend emerges. This could result in significant misallocation of economic resources, as prospective merging parties weigh the gains of acting quickly and with less information to get a potentially valuable vertical merger through before the door closes on their competitors, against the potential losses of merging early when doing so turns out to be a mistake in retrospect.

5.2 "Nature and Purpose of the Merger"

Here the Agencies may be signaling an intention to treat internal documents that show plans to dedicate some or all of the upstream merging firm's capacity to the internal supply of the downstream merging firm as reflecting a purpose to foreclose downstream rivals. But, without more, plans for internal redeployment of input capacity are consistent with procompetitive motives, such as reducing costs (e.g., by eliminating double marginalization or realizing efficiencies in production or distribution) or facilitating investment in quality improvements through improved coordination, all of which can help the merged firm to win business from rivals on the merits.

The Agencies should take care not to conflate plans to win business from rivals on the merits—the essence of competition—with the foreclosure of rivals. In both cases, the merged firm's share in the relevant market can be expected to grow at rivals' expense. What matters for merger analysis is the source of that growth: whether it derives from improvements realized by the merged firm that sharpen competition in the relevant market, or from artificial impediments to rivals' competition that the merged firm has the ability and incentive to introduce post-merger.

5.3 "The Relevant Market is Already Concentrated"

As a matter of economics, concentration in the relevant market is not a reliable indicator of vertical merger harm. The work of Sheu and Taragin establishes this within a rigorous economic model, as discussed above.[28]

There are also circumstances where higher concentration is associated with a lower likelihood of foreclosure. A more highly concentrated relevant market can be due to there being fewer and larger rivals to the merged firm. The merged firm's ability to foreclose such

[28] *See* Sheu & Taragin, *supra* note 18, at 598.

rivals may be poor, given that larger and more sophisticated firms can have more options to secure trade in the related product market, having the wherewithal to themselves integrate into the related market or to sponsor entry into that market.[29]

5.4 "The Merger Increases Barriers to Entry"

Here the DMGs state that "a new entrant would need to invest not only in entering the relevant market, but also in the related market, sometimes referred to as two-stage entry."[30] But, again, the Agencies should take care not to conflate competition with foreclosure. If a vertical merger were to generate substantial procompetitive effects (EDM and efficiencies), this could pose hard challenges for rivals—both incumbents and potential entrants. However, in this case rivals' post-merger losses of share in the relevant market would reflect an intensification of competition, not foreclosure.

Moreover, an attempted foreclosure strategy by the merged firm could fail by increasing the attractiveness of single-stage entry into the related product market. This prospective outcome is especially likely if there are large rivals to the merged firm in the relevant market that have the ability sponsor entry into the related product market by assuring an entrant large and durable commitments to trade. Put differently, even if two-stage entry were prohibitively costly post-merger, a foreclosure attempt by the merged firm may be defeated by single-stage entry.

6. Conclusions and Recommendations

The economic theory of the firm teaches that vertical (and complementary goods) mergers differ fundamentally from horizontal mergers. Given incomplete contracting, improved coordination post-merger between the merging parties tends to increase competition and improve market outcomes in the case of vertical merger but tends to lessen competition and degrade market outcomes in the case of horizontal merger. Although countervailing effects render some vertical mergers anticompetitive and most horizontal

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[29] For an early paper applying a similar idea involving threats to backward integration, *see* Michael L. Katz, *The Welfare Effects of Third-Degree Price Discrimination in Intermediate Goods Markets*, 77 AMER. ECON. REV. 154 (1987).

[30] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, *supra* note 1, at 18.

mergers competitively neutral or procompetitive, rational merger analysis should take the fundamental differences of these merger types into account.

The economic analysis of Section II.5 of the DMGs conveys a rational—though incomplete—antitrust treatment of vertical mergers based on sound economic analysis. The one glaring omission in Section II.5 is the absence of any discussion of EDM—the elimination of double marginalization—a feature typically inherent to vertical mergers. EDM arises from improved coordination between the merging parties, with the salutary effect of increasing competition in the relevant market that can manifest as improvements in the merged firm's price or non-price features. We urge the Agencies to add a discussion of EDM to Section II.5 of the DMGs.

Section II.6 of the DMGs, however, stands in stark contradiction to the economic analysis in Section II.5. The market-share threshold for a presumption of harm in Section II.6 has no support in either economics or legal precedent, and the "plus factors" when the presumption threshold is not triggered offer no reliable indicators of competitive harm. We urge the Agencies to entirely eliminate Guideline 6 and the material in Section II.6 of the DMGs.