

**DOJ/FTC Draft 2020 Vertical Merger Guidelines  
Comment of the Global Antitrust Institute,  
Antonin Scalia Law School, George Mason University**

*February 7, 2020*

This Comment is submitted to the Department of Justice and the Federal Trade Commission (FTC) for consideration in relation to their draft 2020 Vertical Merger Guidelines (“VMGs”).<sup>1</sup> We submit this Comment based upon our extensive experience and expertise in antitrust law and economics.<sup>2</sup> The Global Antitrust Institute (GAI) is committed to promoting sound economic analysis as the foundation of antitrust enforcement and competition policy, and commends the agencies for inviting discussion on the proposed Guidelines. The GAI would also welcome an opportunity to participate in any upcoming workshops on the VMGs.

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<sup>1</sup> See U.S. Dep’t of Justice & Fed. Trade Comm’n, *Draft Vertical Merger Guidelines*, Jan. 10, 2020, <https://www.ftc.gov/news-events/press-releases/2020/01/ftc-doj-announce-draft-vertical-merger-guidelines-public-comment> (hereinafter “VMGs”).

<sup>2</sup> The Global Antitrust Institute (GAI), a division of the Antonin Scalia Law School at George Mason University (Scalia Law), is a leading international platform for economic education and research that focuses upon the legal and economic analysis of key antitrust issues confronting competition agencies and courts around the world. University Professor Joshua D. Wright, Ph.D. (economics), is the Executive Director of the GAI and a former U.S. Federal Trade Commissioner. John M. Yun, Ph.D. (economics) is the Director of Economic Education of the GAI, Associate Professor of Law at Scalia Law, and a former Acting Deputy Assistant Director in the Bureau of Economics, U.S. Federal Trade Commission. Professor of Law Douglas H. Ginsburg is a Senior Judge, United States Court of Appeals for the District of Columbia Circuit, Chairman of the GAI’s International Board of Advisors, and a former Assistant Attorney General in charge of the Antitrust Division of the U.S. Department of Justice. Tad Lipsky is the Director of GAI’s Competition Advocacy Program, Adjunct Professor at Scalia Law, a former Deputy Assistant Attorney General for Antitrust and a former Acting Director, Bureau of Competition, U.S. Federal Trade Commission. The GAI gratefully acknowledges the assistance of Scalia Law students Timothy Swartz and Harrison Kummer in the preparation of this comment.

## Introduction

One purpose of antitrust enforcement agency guidelines, including the draft VMGs, is to offer greater transparency, predictability, and consistency to the antitrust community (legal practitioners, antitrust economists, scholars, businesses and individuals, journalists among others) as to how the agencies will generally conduct vertical merger investigations and make enforcement decisions. An equally important objective of agency enforcement guidelines is to ensure that the analytical framework adopted promotes sound antitrust policy. We believe those objectives will be best achieved with VMGs that clearly articulate an analytical framework based upon sound economic principles and empirical evidence.

The proposed VMGs largely achieve these objectives. They clearly would offer greater transparency, predictability, and consistency. First, they expressly withdraw and supersede the 1984 Non-Horizontal Guidelines.<sup>3</sup> Whatever one's view of the 1984 guidelines, it was becoming increasingly unclear what role, if any, they played in agency deliberations. The proposed VMGs also explicitly link the 2010 Horizontal Merger Guidelines to vertical merger analysis, which, again, offers greater clarity—even if many practitioners already presumed this to be the case.<sup>4</sup>

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<sup>3</sup> See U.S. Dep't of Justice, *Non-Horizontal Merger Guidelines* (1984), [www.justice.gov/atr/public/guidelines/2614.pdf](http://www.justice.gov/atr/public/guidelines/2614.pdf).

<sup>4</sup> The VMGs' recognition of a broad analytical overlap between horizontal and vertical mergers is consistent with the legacy of the 1984 Non-Horizontal Merger Guidelines; they were inserted (as "Section 4") into the 1984 Horizontal Merger Guidelines to form the composite 1984 Merger Guidelines.

The proposed VMGs also generally advance the second objective of articulating an analytical framework for vertical mergers based upon sound economic principles. For example, the proposed VMGs reject presumptions of illegality or legality in favor of a case-by-case approach driven by economic issues identified in the guidelines.<sup>5</sup> In this comment, we focus upon identifying a series of recommendations to connect the VMGs more deeply to sound economics and our empirical understanding of the competitive consequences of vertical integration.

More specifically, we focus upon four issues: (1) incorporating the elimination of double marginalization into the analysis of the likelihood of a unilateral price effect rather than treating it separately; (2) eliminating the role of market shares and structural analysis in the VMGs; (3) highlighting that the weight of empirical evidence supports the proposition that vertical mergers are less likely to generate competitive concerns than are horizontal mergers; and (4) recognizing the importance of reduced transaction costs in analyzing the efficiencies commonly associated with vertical mergers.

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<sup>5</sup> These issues include considering cognizable efficiencies and weighing them against potential findings of anticompetitive harm. *See* VMGs at 9 (“Because vertical mergers combine complementary economic functions and eliminate contracting frictions, they have the potential to create cognizable efficiencies that benefit competition and consumers . . . The Agencies do not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is unlikely to be anticompetitive in any relevant market.”).

## **Elimination of Double Marginalization is a Unilateral Price Effect**

The elimination of double marginalization (EDM) is discussed separately both from unilateral price effects, in Section 5, and from efficiencies, in Section 9, of the draft VMGs. This is notable because the structure of the VMGs obscures the relevant economics of internalizing pricing externalities and may encourage the misperception that EDM is a special or unusual form of efficiency.

When separate upstream and downstream entities price their products, they do not fully take into account the effect their pricing decisions have upon each the other—even though they are part of the same value chain for a given product. Consider, for instance, a two-stage production process involving two independent firms. If we assume that both have downward-sloping demand curves—meaning that marginal revenue declines faster than demand at each stage—then there will be two markups. The markup at each stage results in raising price above marginal cost with a corresponding reduction in output. While an integrated firm could certainly continue to price each stage as if they were two separate entities, to do so would be to leave potential profits on the table. This is because vertical integration enables the firm to effectively “evade” the markup at the first stage. The result is greater output, profits, and consumer surplus. As Spengler (1950) noted long ago, “*ceteris paribus*, the greater the ‘monopolistic’ surcharges being levied in earlier stages and the higher the variable

costs in the later stages ... the greater will be the price reductions this firm finds advisable.”<sup>6</sup>

In other words, a vertical merger eliminates a pricing externality since the post-merger upstream and downstream units are fully aligned in terms of their pricing incentives. In this regard, EDM is indistinguishable from the unilateral effects that may create an incentive to raise price, as discussed in Section 5 of the VMGs. Specifically, in the context of mergers, unilateral effects are about the incentive to change price (or quantity, quality, or innovation) as a result of combining two previously independent economic decision-makers—which is not based upon achieving some reduction in cost. Just as there is a greater incentive, under certain conditions, to foreclose rivals or to raise rivals’ costs (RRC) post-merger (quite apart from the *ability* to do so), there is an incentive post-merger to lower prices due to the elimination of a markup along the supply chain. Consequently, one cannot accurately assess unilateral effects without accounting for the full set of incentives that could move prices in either direction. In Section 5.a, the draft VMGs recognize this to a degree:

[T]he Agencies may construct economic models designed to quantify the likely unilateral price effects resulting from the merger. These models often include independent price responses by non-merging firms. They also can incorporate the elimination of double marginalization (see Section 6) to give a likely net effect from changes to pricing incentives, as well as incorporate cognizable efficiencies (see Section 8).<sup>7</sup>

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<sup>6</sup> See Joseph J. Spengler, *Vertical Integration and Antitrust Policy*, 58 J. POL. ECON. 347, 350 (1950).

<sup>7</sup> VMGs at 4.

While this passage recognizes that EDM can put downward pressure on prices, it is not appropriate to consider EDM as a factor in the calculation of a “net effect,” a phrase closely associated with weighing efficiencies against findings of anticompetitive harm. Rather, “unilateral price effects” actually *include* EDM<sup>8</sup>—just as a finding that a merger will induce entry is properly included in a unilateral effects analysis. For these reasons, we suggest incorporating the discussion of EDM into the discussion of unilateral effects in Section 5 of the VMGs and eliminating Section 6. Segregating EDM in its own section creates a sort of “limbo” between unilateral effects and efficiencies—which can only create confusion—particularly among courts.

As a final point, the VMGs note that: “The effects of the elimination of double marginalization may be lower if, prior to the merger, the merging parties already

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<sup>8</sup> See, e.g., Gopal Das Varma & Martino De Stefano, *Equilibrium Analysis of Vertical Mergers* 2–3 (Dec. 10, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3307150](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3307150) (“ . . . RRC [“raising rivals’ costs”] and EDM are not two separate effects. Instead, they are inseparably linked because the extent of EDM affects the strength of the RRC incentive, making EDM to be not just a stand-alone competitive benefit to be weighed against RRC.”); Daniel P. O’Brien, *The Antitrust Treatment of Vertical Restraints: Beyond the Possibility Theorems*, in REPORT: THE PROS AND CONS OF VERTICAL RESTRAINTS 40, 51 (2008), <http://www.konkurrensverket.se/globalassets/english/research/report-the-pros-and-cons-of-vertical-restraints-18mb.pdf> (“The biggest contribution of the successive monopoly model to the literature, in my view, is to show that Cournot’s insight that the joint pricing of complements leads to lower prices extends to the sequential pricing of complements that occurs between firms in a vertical relationship.”); see also Serge Moresi & Steven C. Salop, *vGUPPI: Scoring Unilateral Pricing Incentives in Vertical Mergers*, 79 ANTITRUST L.J. 185 (2013) (calling EDM an “efficiency” but clearly considering it an integral part of the merged firm’s unilateral incentives: “A vertical merger can create unilateral incentives for the upstream merging firm to raise the prices of its inputs to the competitors of the downstream merger partner and also can create unilateral incentives for the downstream merging firm to reduce prices as a result of vertical efficiencies, particularly EDM. These are the central incentives driving input foreclosure concerns and efficiency rationales in vertical merger cases.”); Gleb B. Domnenko & David S. Sibley, *Simulating Vertical Mergers and the Vertical GUPPI Approach* 4 (Jan. 1, 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3447687](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3447687).

engaged in contracting that aligned their incentives.”<sup>9</sup> It is also important to emphasize that the mere existence of a contract capable of mitigating double marginalization does not tell us about its efficacy compared to vertical integration.<sup>10</sup> It is important to note there are costs to contracting,<sup>11</sup> which we explore later in this comment.

### **Role of Market Shares and Structural Analysis**

In Section 3 (“Market Participants, Market Shares, and Market Concentration”), there are two notable statements. First, “[t]he Agencies ... do not rely on changes in concentration as a screen for or indicator of competitive effects from vertical theories of harm.”<sup>12</sup> This statement, without further explanation, is puzzling as there are no *changes* in concentration caused by vertical mergers.<sup>13</sup>

The second statement of note is the following: “The Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant

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<sup>9</sup> VMGs at 7.

<sup>10</sup> See O’Brien, *supra* note 8, at 63 (“The use of nonlinear contracts can mitigate double-marginalization, but it does not necessarily eliminate it.”).

<sup>11</sup> See, e.g., Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. LAW & ECON. 297, 298 (1978) (“The crucial assumption analysis of this paper is that, as assets become more specific and more appropriable quasi rents are created (and therefore the possible gains from opportunistic behavior increases), the costs of contracting will generally increase more than the costs of vertical integration.”); Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. REV. 112, 113 (1971) (“In circumstances, therefore, where protracted bargaining between independent parties to a transaction can reasonably be anticipated, internalization becomes attractive.”).

<sup>12</sup> VMGs at 3.

<sup>13</sup> Of course, there could be horizontal overlaps in addition to the vertical component of a merger that would lead to changes in concentration; however, this is more of a standard horizontal merger analysis rather than a vertical one.

market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market.”<sup>14</sup> The very next sentence reads: “In some circumstances, mergers with shares below the thresholds can give rise to competitive concerns.”<sup>15</sup> From this, we conclude that the VMGs implicitly adopt the view that, if both the relevant product and the related product have a less than a 20 percent share in the relevant market, the acquisition is either competitively neutral or benign. Elsewhere, however, the VMGs make clear they do not offer a safe harbor.<sup>16</sup> With these statements, there is a significant risk that the 20 percent figure will be interpreted by counsel or courts as a trigger for competitive concern. There is no sound economic reason, however, to believe a 20 percent share in the relevant market or in the related market is of any particular importance as a predictor of competitive effects. We suggest the agencies eliminate discussion of market shares altogether; it is not useful to their analysis and invites confusion among outsiders. At a minimum, the final guidelines would benefit from some explanation for this threshold if it is retained.

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<sup>14</sup> VMGs at 3.

<sup>15</sup> *Id.*

<sup>16</sup> The draft VMGs clarify that “a share of 20 percent or more in the relevant market or a related products’ share of use in the relevant market of 20 percent or more, or both, does not, on its own, support an inference that the vertical merger is likely to substantially lessen competition.” VMGs at 3.



## Empirical Evidence on the Welfare Impact of Vertical Mergers

In contrast to vertical mergers, horizontal mergers inherently involve a degree of competitive overlap and an associated loss of at least some degree of rivalry between actual and/or potential competitors. This loss of competition is the basis for the economic models used to predict post-merger price increases and other anticompetitive effects—including merger simulations and, more recently, GUPPIs.<sup>17</sup> Therefore, absent efficiencies or entry or other dynamic considerations, every horizontal merger involves some, perhaps nominal, loss of rivalry between competitive firms and standard, static, economic models typically will predict an associated price increase.<sup>18</sup>

The price effect for vertical mergers, however, is generally theoretically ambiguous—even before accounting for efficiencies—due to EDM and the uncertainty regarding whether the integrated firm has an incentive to raise rivals' costs or foreclose.<sup>19</sup> Thus, for vertical mergers, empirical evaluation of the welfare effects of consummated mergers has been and remains an important area of research for guiding antitrust policy. As stated by Lafontaine and Slade (2007), empirically evaluating

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<sup>17</sup> For more on GUPPIs, see Steven C. Salop & Serge Moresi, *Updating the Merger Guidelines: Comments* (Nov. 9, 2009), [https://www.ftc.gov/sites/default/files/documents/public\\_comments/horizontal-merger-guidelines-review-project-545095-00032/545095-00032.pdf](https://www.ftc.gov/sites/default/files/documents/public_comments/horizontal-merger-guidelines-review-project-545095-00032/545095-00032.pdf).

<sup>18</sup> See Joseph Farrell & Carl Shapiro, *Horizontal Mergers: An Equilibrium Analysis*, 80 AM. ECON. REV. 107, 118 (1990).

<sup>19</sup> See Spengler, *supra* note 6, at 347 (“Vertical integration, on the contrary, does not, as such, serve to reduce competition and may, if the economy is already ridden by deviations from competition, operate to intensify competition.”). See also *supra* note 8 and accompanying text (arguing that EDM is subsumed within unilateral effects).

vertical mergers allows us to address “what are the consequences of vertical integration for economic outcomes such as prices, quantities, investment, and profits?”<sup>20</sup> These questions are “important ultimately as input into the development of sensible vertical merger policy and related government intervention in vertical relationships.”<sup>21</sup> Indeed, “evidence-based antitrust” requires testing economic theories with economic knowledge and empirical data to support those theories with the best predictive power.”<sup>22</sup>

Noticeably absent from the draft guidelines, however, is any empirical grounding. Consistent empirical findings should inform the agencies’ approach to decision-making. Indeed, the FTC spent a great deal of time on this issue at its recent hearing on vertical mergers.<sup>23</sup> The two most widely cited economic studies that summarize the empirical evidence on vertical integration are Lafontaine & Slade (2007) and Cooper *et al.* (2005).<sup>24</sup> After comprehensively reviewing prior vertical integration research, Lafontaine & Slade conclude: “[C]onsistent with the large set of efficiency

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<sup>20</sup> See Francine Lafontaine & Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence*, 45 J. ECON. LITERATURE 629, 629 (2007).

<sup>21</sup> *Id.* at 630.

<sup>22</sup> Joshua D. Wright, *Abandoning Antitrust’s Chicago Obsession: The Case for Evidence-Based Antitrust*, 78 ANTITRUST L.J. 241, 242–43 (2012).

<sup>23</sup> See Fed. Trade Comm’n, *FTC Hearing #5: Vertical Merger Analysis and the Role of the Consumer Welfare Standard in U.S. Antitrust Law* (Nov. 1, 2018), HEARINGS ON COMPETITION AND CONSUMER PROTECTION IN THE 21ST CENTURY, <https://www.ftc.gov/news-events/events-calendar/ftc-hearing-5-competition-consumer-protection-21st-century>.

<sup>24</sup> Lafontaine & Slade, *supra* note 20; James C. Cooper et al., *Vertical Antitrust Policy as a Problem of Inference*, 23 INT’L J. INDUS. ORG. 639 (2005).

motives for vertical mergers that we have described so far, the evidence on the consequences of vertical mergers suggests that consumers mostly benefit ....<sup>25</sup>

Similarly, Cooper *et al.* report: “Most studies find evidence that vertical restraints/vertical integration are procompetitive.”<sup>26</sup> Additionally, O’Brien (2008) states that “the empirical literature on [resale price maintenance and exclusive territories], vertical integration, and non-linear contracting suggests that these practices have been used to mitigate double marginalization and induce demand increasing activities by retailers. With few exceptions, the literature does not support the view that these practices are used for anticompetitive reasons.”<sup>27</sup>

In a 2018 comment to the FTC, we aimed to update the evidence on vertical mergers since the work summarized above.<sup>28</sup> Specifically, the GAI examined published research in peer-reviewed journals since 2008 that empirically analyzed the welfare consequences of vertical mergers in the U.S.<sup>29</sup> We found the empirical evidence from 2009-2018 continues to support the conclusions reached by Lafontaine & Slade and by

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<sup>25</sup> Lafontaine & Slade, *supra* note 20, at 663.

<sup>26</sup> Cooper *et al.*, *supra* note 24, at 658.

<sup>27</sup> O’Brien, *supra* note 8, at 76.

<sup>28</sup> See Global Antitrust Institute, Comment Letter on Federal Trade Commission’s Hearings on Competition and Consumer Protection in the 21st Century, Vertical Mergers, (George Mason Law & Economics Research Paper No. 18-27, Sept. 6, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3245940](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3245940).

<sup>29</sup> Our comment did not offer an exhaustive list of the literature but provided more of a snapshot of research available on EconLit and in a general web search. See *id.* at 6.

Cooper *et al.* that consumers benefit from most vertical integration.<sup>30</sup> The following table summarizes the findings of these empirical studies.

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<sup>30</sup> Of the original thirteen papers examined, one should have been omitted: Orley C. Ashenfelter *et al.*, *Efficiencies Brewed: Pricing and Consolidation in the US Beer Industry*, 46 *RAND J. ECON.* 328 (2015), since it did not involve a vertical component to the examined merger. Further, we received some pushback for characterizing Crawford *et al.*'s study as showing positive welfare effects. See Gregory S. Crawford *et al.*, *The Welfare Effects of Vertical Integration in Multichannel Television Markets*, 86 *ECONOMETRICA* 891 (2018). On this point, however, others have reached the same conclusion about Crawford *et al.*'s overall findings. For instance, Froeb *et al.* (2018) state: "Crawford *et al.* (2017) [*sic*]...find that vertical integration between regional sports networks and cable TV distributors results in increased geographic distribution of the networks and a corresponding increase in consumer and total welfare." Luke M. Froeb *et al.*, *Economics at the Antitrust Division: 2017-2018*, 53 *REV. INDUS. ORG.* 637, 649 (2018). In a later article, the authors of the original Crawford *et al.* study summarize their results in the following manner: "We also are able to examine how these two effects [*i.e.*, anticompetitive and procompetitive effects] net out for consumer welfare. We find a fair amount of heterogeneity, with some markets showing complete foreclosure and consumer losses from vertical integration at our point estimates. (However, we are not able to statistically reject the possibility that those individual cases had no consumer harm.) Overall, however, on average across 26 RSNs, we find that there would be a statistically significant positive effect on consumer welfare from vertical integration, despite the incentives for foreclosure that it would create." See Crawford *et al.*, *AT&T/Time Warner and Antitrust Policy Toward Vertical Mergers*, *CPI Antitrust Chronicle*, July 2019 at 3. In sum, even with the Ashenfelter *et al.* correction and moving Crawford *et al.* to "mixed" welfare effects, we still find the overwhelming majority of studies are consistent with the idea that vertical mergers do not result in negative welfare effects.

**Table: The Welfare Effects of Vertical Integration (2009-2018)<sup>31</sup>**

Author	Year	Industry	Data/Technique	Variable Examined (x)	Effect on x	Effect on Welfare
Suzuki	2009	Multichannel Television	Panel; Difference-in-Differences	Cost Foreclosure	- +	mixed
Hanssen	2010	Motion Pictures	Cross-Sectional	Film Run Adjustments Foreclosure	+ no effect	+
Taylor <i>et al.</i>	2010	Retail Gasoline	Panel; Difference-in-Differences	Price	+(close to zero)	no economic significance
Forman & Gron	2011	Insurance	Panel	Adoption of Information Technology	+(at one level) & no effect (at another level)	not addressed
Malik	2011	Pharmaceutical	Panel	New Product Development	+	+
Cohen	2013	Retail Milk	Panel	Simulated Effects on Price from Vertical Divestiture	-	-
Atalay <i>et al.</i>	2014	Various	Panel	Productivity	+	+
Baker <i>et al.</i>	2014	Hospitals	Panel	Price-Spending Hospital Admissions	+ -	mixed to negative
Austin	2015	Retail Gasoline	Panel	Price	-	+
Gil & Warzynski	2015	Video Games	Panel	Price Quantity Quality	+ + +	+
Koch <i>et al.</i>	2017	Hospitals	Panel; Difference-in-Differences	Physician Hospital Utilization Spending	+ mixed	not addressed
Crawford <i>et al.</i>	2018	Multichannel Television	Panel	Price	-	mixed to positive

<sup>31</sup> The included studies are Ayako Suzuki, *Market Foreclosure and Vertical Merger: A Case Study of the Vertical Merger Between Turner Broadcasting and Time Warner*, 27 INT'L J. INDUS. ORG. 532 (2009); F. Andrew Hanssen, *Vertical Integration During the Hollywood Studio Era*, 53 J.L. & ECON. 519 (2010); Christopher T. Taylor *et al.*, *Vertical Relationships and Competition in Retail Gasoline Markets: Empirical Evidence from Contract Changes in Southern California: Comment*, 100 AM. ECON. REV. 1269 (2010); Chris Forman & Anne Gron, *Vertical Integration and Information Technology Investment in the Insurance Industry*, 27 J.L. ECON. & ORG. 180 (2011); Tariq Malik, *Vertical Alliance and Vertical Integration for the Inflow of Technology and New Product Development in the Pharmaceutical Industry*, 23 TECH. ANALYSIS & STRATEGIC MGMT. 851 (2011); Michael A. Cohen, *A Study of Vertical Integration and Vertical Divestiture: The Case of Store Brand Milk Sourcing in Boston*, 22 J. ECON. & MGMT. STRATEGY 101 (2013); Enghin Atalay *et al.*, *Vertical Integration and Input Flows*, 104 AM. ECON. REV. 1120 (2014); Laurence C. Baker *et al.*, *Vertical Integration: Hospital Ownership of Physician Practices is Associated with Higher Prices and Spending*, 33 HEALTH AFF. 756 (2014); Joshua Karl Austin, *Vertical Integration and Pricing Outcomes in Retail Gasoline Markets*, 35 ECON. BULL. 1 (2015); Ricard Gil & Frederic Warzynski, *Vertical Integration, Exclusivity, and Game Sales Performance in the US Video Game Industry*, 31 J.L. ECON. & ORG. 143 (2015); Thomas G. Koch *et al.*, *How Vertical Integration Affects the Quantity and Cost of Care for Medicare Beneficiaries*, 52 J. HEALTH ECON. 19 (2017); Gregory S.

While vertical integration can certainly foreclose rivals in theory, there is only limited empirical evidence supporting that finding in real markets. The results continue to suggest that the modern antitrust approach to vertical mergers should reflect the empirical reality that vertical relationships are generally procompetitive or neutral.

The infrequency of vertical mergers with anticompetitive effects should be reflected in the agencies' framework and presumptions. Given the strong empirical evidence that vertical mergers do not tend to result in welfare losses for consumers, we believe the agencies should make at least the modest statement that vertical mergers are more often than not procompetitive or, alternatively, that vertical mergers tend to be more procompetitive or neutral than are horizontal mergers. Thus, we believe the final VMGs would benefit from a statement similar to this from the 1984 VMGs: "Although nonhorizontal mergers are less likely than horizontal mergers to create competitive problems, they are not invariably innocuous."<sup>32</sup> Since 1984, the empirical literature has only strengthened the validity of this statement, the economic roots of which date back to the original work of Spengler (1950).<sup>33</sup>

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Crawford et al., *The Welfare Effects of Vertical Integration in Multichannel Television Markets*, 86 *ECONOMETRICA* 891 (2018).

<sup>32</sup> 1984 Non-Horizontal Merger Guidelines at 23.

<sup>33</sup> See Spengler, *supra* note 6, at 347 ("Vertical integration, on the contrary, does not, as such, serve to reduce competition and may, if the economy is already ridden by deviations from competition, operate to intensify competition.").

## Transaction Cost Efficiencies and Merger Specificity

The VMGs address efficiencies in Section 8, which provides: “The Agencies will evaluate efficiency claims by the parties using the approach set forth in Section 10 of the 2010 Horizontal Merger Guidelines.” Under that approach, efficiencies must be both cognizable and merger-specific to be considered. Moreover, when evaluating the merger specificity of an efficiency, the 2010 HMGs say the Agencies “do not insist upon a less restrictive alternative that is merely theoretical.”<sup>34</sup>

The VMGs’ treatment of efficiencies implicitly recognizes the extensive empirical evidence regarding both the efficiency of vertical integration by noting that because “vertical mergers combine complementary economic functions and eliminate contracting frictions, they have the potential to create cognizable efficiencies that benefit competition and consumers.”<sup>35</sup> The VMGs also explicitly recognize the different costs and performance of contracts as compared to vertical integration. The VMGs importantly note that a “single firm able to coordinate how these assets are used may be able to streamline production, inventory management, or distribution, or create innovative products in ways that would have been hard to achieve through arm’s length contracts.”<sup>36</sup>

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<sup>34</sup> U.S. Dep’t of Justice & Fed. Trade Comm’n, *Horizontal Merger Guidelines*, at 30, Aug. 19, 2010, <https://www.justice.gov/atr/horizontal-merger-guidelines-08192010>.

<sup>35</sup> VMGs at 9.

<sup>36</sup> *Id.*

In general, the VMGs adopt an approach that is consistent with the teachings of the robust literature on transaction costs economics, which recognizes the costs of using the price system as explaining the boundaries of economic organizations,<sup>37</sup> and the importance of incorporating such considerations into any antitrust analyses.<sup>38</sup> In particular, this literature has demonstrated, both theoretically and empirically, that the decision whether to contract or to vertically integrate is often driven by the relatively high costs of contracting<sup>39</sup> as well as by concerns regarding the enforcement of contracts,<sup>40</sup> and opportunistic behavior.<sup>41</sup> This literature suggests that such transaction costs efficiencies in the vertical merger context often will be both cognizable and merger-specific,<sup>42</sup> and rejects an approach that would presume such efficiencies are not merger specific because they can theoretically be achieved via contract.<sup>43</sup>

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<sup>37</sup> See Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937); Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 *AM. ECON. REV.*, 112 (1971). For a summary of the empirical literature, see the discussion in Lafontaine and Slade, *supra* note 20.

<sup>38</sup> See Dennis W. Carlton & Bryan Keating, *Antitrust, Transaction Costs, and Merger Simulation with Nonlinear Pricing*, 58 *J.L. & ECON.* 269 (2015); Dennis W. Carlton & Bryan Keating, *Rethinking Antitrust in the Presence of Transaction Costs: Coasian Implications*, 46 *REV. INDUS. ORG.* 307 (2015).

<sup>39</sup> See, e.g., Ricard Gil & Wesley R. Hartmann, *Airing Your Dirty Laundry: Vertical Integration, Reputational Capital and Social Networks*, 27 *J.L. ECON. & ORG.* 219 (2011).

<sup>40</sup> See Ronald H. Coase, *The Problem of Social Cost*, 3 *J.L. & ECON.* 1 (1960); Harold Demsetz, *The Exchange and Enforcement of Property Rights*, 7 *J.L. & ECON.* 11 (1964).

<sup>41</sup> See Benjamin Klein et al., *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, 21 *J.L. & ECON.* 297 (1978); Benjamin Klein, *Fisher-General Motors and the Nature of the Firm*, 43 *J.L. & ECON.* 105 (2000).

<sup>42</sup> See, e.g., Statement of Professor Francine Lafontaine, Fed. Trade Comm'n, Hearings on Competition and Consumer Protection in the 21st Century, Tr. at 73, Nov. 1, 2018 (vertical contracts “do not easily generate the same outcome as what a vertical merger could do because of demand uncertainty, risk aversion, information asymmetries,...[and] incentive problems.”).

<sup>43</sup> See, e.g., Jonathan B. Baker et al., *Five Principles for Vertical Merger Enforcement Policy*, 33 *ANTITRUST* 12 (2019).



While we agree with the overall approach set out in the VMGs, we are concerned that the application of Section 8, in practice, without more specificity and guidance, will be carried out in a way that would make it extremely difficult for parties to be credited for their legitimate efficiencies. For instance, Section 10 of the 2010 HMGs, which the VMGs explicitly reference, tends to be interpreted, in practice, in a manner that makes it highly unlikely that the efficiencies will be credited when there is a showing of anticompetitive harm.<sup>44</sup> We should not export this approach to the assessment of vertical mergers.

### **Conclusion**

In sum, we commend the agencies for proposing VMGs that largely achieves the objective of offering greater transparency, predictability, and consistency to the relevant stakeholders. The proposed VMGs also generally advance the second objective of articulating an analytical framework for vertical mergers based upon sound economic principles. Specifically, the proposed VMGs reject presumptions of illegality or legality in favor of a case-by-case approach. Overall, the agencies deserve credit for highlighting the relevant factors in assessing vertical mergers and for not attempting to

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<sup>44</sup> See, e.g., Brian Facey et al., *Mind the Gap: Merger Efficiencies in the United States and Canada*, 32 ANTITRUST 64, 66 (2018) (“In the United States, the efficiencies defense generally lands like a dubious alibi—necessarily considered but very seldom credited.”); Erin L. Shencopp & Nathaniel J. Harris, *Using Efficiencies to Defend Mergers: The Current Legal Landscape*, ANTITRUST SOURCE, April 2019, at 1, 5 (“courts tend to conclude either that the efficiencies are not merger-specific or verifiable, or that the merger will not harm competition and appears to generate efficiencies.”).

be overly aggressive in advancing untested merger assessment tools or theories of harm.

The agencies should seriously consider, however, refinements in a number of critical areas. First, discussion of the EDM should be integrated into the larger unilateral effects analysis in Section 5 of the VMGs—as incentives to foreclose or raise rivals’ costs cannot be fully assessed without also considering the downward pressure on prices from EDM. Second, the agencies should eliminate the role of market shares and structural analysis in the VMGs. Third, the final VMGs should acknowledge the weight of the empirical evidence, which supports the proposition that vertical mergers are less likely to generate competitive concerns than horizontal mergers. Finally, the final VMGs should recognize the importance of transaction cost-based efficiencies. We believe incorporating these changes will result in guidelines that are in conformity with sound economics and the empirical evidence.