COMMENTS ON THE JANUARY 2020 DRAFT VERTICAL MERGER GUIDELINES

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1. Introduction

We offer these comments on the Draft Vertical Merger Guidelines released by the U.S. Department of Justice and the Federal Trade Commission ("the agencies") on January 10, 2020 (hereafter the "draft guidelines"). Our aim is to provide input that will help improve the final guidelines and further the goal of providing useable guidance to practitioners and to the business community. To that end, the draft guidelines and this comment process are a welcome improvement over the lingering fragments from section 4 of the 1984 Merger Guidelines that had remained the only published form of guidance from the agencies for over 35 years. Those fragments had no mention of vertical merger theories that have come to be at the forefront of modern enforcement, such as foreclosure and raising rivals' costs.

Our goal with these comments is not to advocate for any particular policy choice. Instead, we discuss several points of confusion about vertical mergers that the draft guidelines allow to persist. We believe that if implemented without changes, the draft guidelines are likely to create confusion and fail to further clarify the landscape of vertical merger analysis.[1]

One area of confusion that could readily be addressed is the definition of vertical mergers. Many ordinary fact patterns will leave merging parties with questions of whether their merger can or should be analyzed under the vertical merger guidelines. In particular, some mergers of complements appear to be excluded from the scope of the definition provided in the draft guidelines, despite the competitive issues typically being similar to those of vertical mergers. Other mergers might be argued to have both vertical and horizontal components. The draft guidelines do not particularly acknowledge these issues or provide guidance on how to resolve such situations. Such ambiguity invites debates that could be avoided.

We recognize that, compared to horizontal mergers, vertical mergers involve a much wider range of scenarios and possible merger effects, and therefore it has proven more difficult to propose a single unifying framework for vertical merger analysis. Nevertheless, we believe that the guidelines would benefit from setting out a clear framework of what changes when vertically related firms integrate. This framework should precede, and provide the guiding principles for, the discussion of other more

[1] FTC Commissioner Christine Wilson has offered five questions for public input. See "Concurring Statement of Christine S. Wilson, Publication of FTC-DOJ Draft Vertical Merger Guidelines for Public Comment," File No. P810034, January 10, 2020, available at https://www.ftc.gov/public-statements/2020/01/concurring-statement-commissioner-christine-s-wilson-concerning.

detailed aspects of the merger review (e.g., market definition). We propose such a framework below and believe that it is helpful in formulating both the theories of harm for a vertical merger as well as its pro-competitive effects.

We use this framework to address areas of confusion that include: the way markets should be defined and how that connects to the theories of vertical mergers; share thresholds and what relevance each may have in the usual theories of vertical mergers; double marginalization and whether it should be treated distinct from other efficiencies; and some specific issues that raise potential questions about how the agencies will implement vertical analyses.

2. Scope of mergers covered by the draft guidelines

The draft guidelines define vertical mergers as those mergers that "combine firms or assets that operate at different stages of the same supply chain." While the draft guidelines note that "The principles and analytical frameworks used to assess horizontal mergers apply to vertical mergers" and that the draft guidelines "should be read in conjunction with the Horizontal Merger Guidelines," this definition and the existence of two separate guidelines suggests a neat categorization between vertical and horizontal mergers. We believe the suggestion of stark separation could be misleading, and that more guidance is needed on the scope of the vertical merger guidelines and the relationship with the existing horizontal merger guidelines.

Specifically, we see several questions of scope regarding the draft guidelines. First, the brief definition of vertical mergers provided in the guidelines leaves significant uncertainty about whether some vertical relationships are meant to be covered by these draft guidelines. Second, the definition provided in the draft guidelines appears to not apply to mergers of firms that provide (non-vertical) complementary products or services that are combined by customers. Third, the draft guidelines do not explain how the agencies will deal with mergers that involve issues with both horizontal and non-horizontal dimensions.

2.1. Vertical relationships and the supply chain

The brief definition of vertical mergers that is provided in a footnote to the draft guidelines leaves significant uncertainty about how certain typical fact patterns will be treated by the agencies. Below we provide some examples that illustrate possible gray areas that the current definition does not cleanly classify as vertical mergers. Providing an all-inclusive definition might be challenging. However, in our view the draft guidelines are too vague to provide useful guidance.

First, it is unclear whether the current definition applies to so-called "diagonal" mergers. Vertical merger guidelines in other jurisdictions have specifically used this term to refer to mergers where the upstream firm provides inputs to the downstream firm's rivals, but not to the downstream firm directly.[2] In the case of the definition used in the draft guidelines, it is instead unclear whether the term "vertical" is meant to apply at the product level or the market level. In other words, does being part of "the same supply chain" refer only to situations in which one of the merging firms already provides specific inputs to the other? Presumably it also applies more generally to the diagonal case, in situations where the merging parties do not themselves trade pre-merger, but where they do operate in vertically related markets. Would it apply even more broadly to potential suppliers, firms that do not supply anyone within the relevant market today but are expected to in the future?

Second, by simply referring to firms in the "supply chain" the definition leaves room for interpreting what it means to have a vertical relationship. The examples in the draft guidelines are clear but they are also understandably simple, focusing on classical vertical mergers. Many real-world settings involve supply chains where the "verticality" is more complicated. How would the agencies treat more nuanced situations? For example, how would they treat relationships where downstream parties do not take ownership of the product? Or how would they treat relationships which lack a strict flow of goods from one level to the other entirely, with suppliers coming together to jointly produce the final product? The DOJ's challenge to Ticketmaster/LiveNation, described in Box 1 below, provides an example of a real-world merger that presented these sorts of issues. Other sorts of complex interrelationships are common in telecommunications mergers, where carriers often rely on interconnections with other carriers so that each can offer ubiquitous reach to their customers.

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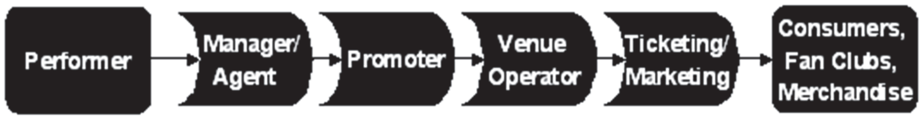
[2] For more on this and other comparison points, see Peter Davis, Kostis Hatzitaskos, and Bob Majure, "Comparison with the EU Non-Horizontal and the UK Merger Assessment Guidelines," January 2020, available at https://www.cornerstone.com/Publications/Articles/Initial-Comparison-US-Draft-Vertical-Merger-Guidelines-to-EU-and-UK.pdf ("Davis, Hatzitaskos, and Majure (2020)"), at § 2.

Box 1: *The Complaint in U.S. and Plaintiff States v. Ticketmaster Entertainment, Inc. and Live Nation Entertainment, Inc., describes the relationships among the various entities involved in putting on a concert at some length. In ¶ 15 it offers the following diagram, which suggests a flow of production:*



However, when the Complaint goes on to describe the relationships between the different levels of this supply chain, it is obvious that those relationships are complicated. For example, managers advise performers on some or all aspects of their business activities, and are often compensated based on a share of the performer's revenues or profits (¶ 16). Booking agents are often hired by managers and assist in arranging concert events or tours. Agents contract with promoters (such as Live Nation) that receive the proceeds from ticket sales and pay for the associated expenses, including the performer. Thus promoters bear the downside risk and upside benefits of a particular event (¶ 17). Venue operators provide facilities and associated services – such as concessions, parking, and security – and traditionally receive both a fixed fee and proceeds from the associated services that they provide (¶ 18). Ticketing companies (such as Ticketmaster) provide ticketing services to venues and promoters, as well as technology and hardware that allow venues to manage fan entry at the event (¶ 19). The Complaint also notes that consumers pay not just the face value of the ticket but also a variety of service fees, and that venues generally receive a split of these fees (¶ 20).

In other words, while the diagram in the Complaint suggests a flow of production, it should be obvious that a concert does not involve firms at one level taking possession of inputs from upstream firms and transforming them into inputs for the next level of firms. Instead, the interactions between firms at different levels in this supply chain and the various revenue-sharing arrangements suggest this is a joint production of the final product.

Third, a merger may transform a market, introducing new combinations and vertical relationships that did not exist pre-merger. For example, a data-rich company may acquire a firm offering a product or service that it can combine with its own data in a way that neither the acquired firm nor its competitors had done previously. Will the agencies use forward-looking analysis and look at supply relationships for the about-to-be upstream and downstream markets?

As a final example, mergers between market participants within a two-sided market may constitute a vertical merger and can give rise to vertical theories of harm. To see this, consider the following example: a booking platform acquires a large hotel chain that is listed on several booking platforms. Booking platforms are a distribution channel for hotels. Therefore, platforms and hotels can be seen as "operating at different stages of the same supply chain." It is unclear whether the agencies intend for such mergers to be captured within their definition of vertical mergers.

2.2. Mergers of complementary products

The Ticketmaster/LiveNation case discussed in Box 1 is an example where suppliers combine their products to jointly produce a final product for customers. As currently offered, the definition of vertical mergers in the draft guidelines appears to not apply to mergers of firms that provide complementary products or services that are combined not by sellers but by customers, since these products are at the same level relative to customers. Furthermore, the merging parties in such cases are also not "actual or potential competitors" for one another, so the horizontal merger guidelines also would not apply to them.[3]

This is in sharp contrast to the economics literature, which has long recognized that the analysis of mergers among complements is similar to the analysis of vertical mergers. This is because mergers tend to raise the same issues and opportunities whether the complements are combined by suppliers or by the customer – the nature of complements is that the products are more valuable together, regardless of who does the combining. This is recognized by competition authorities in the EU and the UK, where guidelines cover mergers for both vertical and complementary relationships.

This omission means that the draft guidelines may appear to leave out a significant portion of non-horizontal deals. This will be particularly salient for certain industries in which non-horizontal mergers have played an important role in recent years. For example:

- In healthcare, it is unclear whether the current definition in the draft guidelines would cover some of the more common combinations, including the acquisition of physician groups by hospital systems, the combination of physician groups across different specialties, and the acquisition of hospitals and out-patient clinics into larger networks.

[3] Horizontal Merger Guidelines, August 19, 2010, at p. 1 ("with respect to mergers and acquisitions involving actual or potential competitors ('horizontal mergers')").

- In the media industry, it is unclear whether the current definition would cover mergers between broadcasters in distinct geographies served by the same cable companies.
- In intellectual property, the current definition would appear not to cover mergers that bring together portfolios of patents that affect the same industry or that are essential to the same standard set by a standard developing organization.

2.3. Mergers with horizontal and non-horizontal dimensions

Many mergers combine horizontal and non-horizontal dimensions, generating more ambiguity over how these mergers will be evaluated. The horizontal and vertical overlap may arise for at least two reasons. First, not all products can cleanly be classified as either substitutes or complements. Second, sometimes merging parties have a vertical relationship in one relevant market while being horizontal competitors in another relevant market.

We observe many markets where products could be interpreted to be both substitutes and complements. Consider the following example from entertainment media. A consumer typically will watch one TV program or listen to one song at a time, and therefore different programs (or songs) are substitutes. However, the customer also has incremental value from the option to choose between more programs or songs, and therefore the programs (and songs) are complements in forming a bundle of content. Another example could be in the telecommunications industry, where fixed line voice, wireless voice, and broadband products are potentially alternative communication channels for the consumer at some point in time, but consumers frequently purchase all three and may particularly value a bundle that combines all three services.

Accordingly, the presence of both the complementary and substitution aspects (and how the firms may choose to emphasize one or the other) can be reflected in the way in which such products are marketed and priced, as well as to how this changes over time. Consider, as an example, that in the early days of TV broadcasting, consumers had independent access to each channel. By contrast, today cable providers generally combine different channels into a single bundle for consumers.

The draft guidelines leave open the question of how the agencies will approach such settings. In determining whether the merger has a complementary goods dimension, how will the agencies determine whether to investigate a merger under the horizontal merger guidelines or another set of guidelines?

Similar issues can arise in mergers that clearly have both horizontal and vertical aspects. For example, consider the merger of two upstream horizontal competitors, one of which is also vertically integrated downstream. How would the agencies be guided in dealing with the interface or interactions between the horizontal and vertical issues that might arise?

The lack of clear guidance on which guidelines might apply when there is ambiguity may contribute to a problem of the agencies or merging parties “pigeon-holing” products into their horizontal or vertical aspects. As a result, the agencies and merging parties could end up disagreeing on which guidelines to apply rather than how a given set of guidelines should apply.

Another alternative might be that the agencies intend for both guidelines to apply when there is ambiguity, so that they analyze both sets of issues. If that is the intent, it would be helpful to be more explicit about this. It would also be helpful to discuss how the agencies might deal with situations where the vertical and horizontal issues might be interrelated. Consider the case of a vertically integrated firm merging with a superior competitor that operates in just one level of the supply chain. In such “vertical upgrade” cases, any evidence that the merger will lead to the elimination of double marginalization or other vertical efficiencies may come at the expense of horizontal competition within the level of the supply chain where the merging parties compete.[4]

Introducing a narrow definition of vertical mergers creates the risk that, rather than focusing on the economic principles and facts that drive the competitive issues, a wide range of merger reviews will fall into a gap where the agency and merging party analysis is driven by the need to fall more clearly under one set of guidelines or the other. This seems especially likely if the final guidelines suggest that vertical mergers are presumed to have procompetitive elements, as has been suggested by some commentators.[5]

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[4] We note that whether it is appropriate to balance benefits and harms across relevant antitrust markets is not a question of economics but rather a legal and agency practice question, one that we understand is generally resolved in US courts and agency practice in favor of not engaging in such balancing.

[5] For example, see Comments on Proposed Vertical Merger Guidelines, Gregory J. Werden and Luke M. Froeb, available at https://www.ftc.gov/policy/public-comments/draft-vertical-merger-guidelines

3. A framework for the economics of vertical mergers

The draft guidelines do not offer a general framework, or general principles, for the analysis of vertical mergers. As noted above, such a framework is more challenging to articulate than in horizontal mergers. It is our view that the lack of such a framework has led, at least in part, to the potential for confusion in vertical merger analysis. We believe the vertical merger guidelines could, and should, do more to provide guidance than the specific examples discussed in the draft guidelines. To demonstrate how the guidelines could offer more guidance, we suggest a framework for understanding the concepts generally at issue.

3.1. The limitations of generalizing vertical mergers

At the risk of grossly over-simplifying, many horizontal mergers tend to raise the same type of competition issues. Consider the merger of two firms whose products are substitutes within a relevant antitrust market. Absent the merger, they cannot expressly agree not to compete without breaking the law. Once they have merged, they fully internalize the impacts their actions have on each other. At the same time, mergers may allow for cost savings and quality improvements that are not achievable without them. The analysis in a horizontal merger review consists of balancing the potentially mitigated incentives the merging parties have to compete, potential cost savings and quality improvements, as well as all the other constraints that will remain on the merging parties' behavior (e.g., other existing competitors, potential entrants, and so on).

As complicated and fact-dependent as horizontal merger review may be in practice, this common framework allows the horizontal merger guidelines to describe a general approach and set out safe harbors or presumptions based on how facts likely relate to the same underlying question.

A central difficulty with writing vertical guidelines is that the range of scenarios that one needs to address is much broader than in horizontal mergers. Many of the same considerations and complications encountered in horizontal mergers are also present in a vertical merger. However, vertical mergers may involve additional

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("The Guidelines' most conspicuous silence concerns the Agencies' general attitude toward vertical mergers, and on how vertical and horizontal mergers differ. This silence is deafening: Horizontal mergers combine substitutes, which tends to reduce competition, while vertical mergers combine complements, which tends to enhance efficiency and thus also competition. Unlike horizontal mergers, vertical mergers produce anticompetitive effects only through indirect mechanisms with many moving parts, which makes the prediction of competitive effects from vertical mergers more complex and less certain.").

nuance given that the competition is between vertically aligned chains of firms, which can be interconnected in many different, often complicated, ways.

In some cases, firms with vertical relationships may use contractual arrangements rather than a merger to align their incentives and abilities, often for obviously pro-competitive ends. However, economic theory tells us that mergers may be an efficient solution when contracts are incomplete – when the best possible contract is still insufficient to achieve the necessary alignment for a given outcome.[6] This means that the competitive impact of many vertical contracts is fact specific and therefore must be evaluated under the rule of reason. For example, exclusive dealing, retail price maintenance, or volume commitments (to name a few) might under certain circumstances harm competition, but are not presumed to be illegal, unlike many agreements among direct horizontal competitors. Similarly, whether mergers that combine vertical incentives and abilities are good or bad for competition is a fact-specific question.

Indeed, any anti-competitive or pro-competitive effects of a vertical merger must be shown to be merger specific. In horizontal mergers we can take as given that a merger relaxes the general prohibition on agreements not to compete, and so we only must ask if prospective efficiencies could have been achieved absent the merger. In a vertical context, one firm's ability to affect the other could be varied and could have significant implications for how to analyze the likelihood and magnitude of effects following a vertical merger.

Recognizing that vertical mergers present a wide variety of possible scenarios, the draft guidelines focus on a series of examples to describe how the agencies would evaluate specific situations while acknowledging that "These effects do not exhaust the types of possible unilateral effects." The lack of a unifying framework in the draft guidelines, however, limits their usefulness in their primary purpose of giving guidance on how vertical mergers in general will be examined.

[6] A lengthy literature in economics is based around the idea that markets may not be able to achieve all the outcomes possible through integration due to incomplete contracts. Contracts are incomplete because it is not possible to specify every eventuality that may occur in the future and how the parties to the contract would behave in each instance. Consolidation is the solution to this problem, achieving full alignment of incentives without a need to anticipate and write down all relevant future states of the world.

3.2. Key elements of a vertical merger framework

Before delving into specific examples, the guidelines could and should clarify that, as a general matter, there are four elements, or questions, that an investigation needs to address.

First, does the merging party in the related market have the **ability** to influence competition in the relevant market? The answer is yes if the merging party in the "related" market has recognizable and sufficient market power to be able to influence the capabilities of participants in the relevant market to produce or sell their products. Consider the following variant of the draft guidelines' Example 2, presented in Box 2 below.

> ***Box 2:*** *A monopolist seller of oranges to firms producing orange juice in a given geographic area (the manufacturers) has the ability to influence competition in the market for manufacturing orange juice. If the seller merges with one of the manufacturers, it can stop supplying some of the other manufacturers or substantially raise their input costs. In that case, rival manufacturers would have no alternative suppliers to turn to and this would reduce their competitiveness (or potentially, cause them to exit the market altogether).*

By contrast, if the related market is very competitive, any attempts to somehow hurt the competitiveness of rivals in the relevant market (for example, by cutting off supplies) will likely be defeated, as these rivals can easily substitute to alternatives and avoid or mitigate the harmful effects on their ability to compete.

In terms of evaluating the existence of substitutes for the related product, it is worth noting that it may call for a different exercise than typical market definition. Horizontal merger analysis generally focuses on relatively predictable changes to an equilibrium that is already observed in the status quo. Vertical mergers can also raise concerns with similarly predictable changes relative to the status quo. However, a typical concern raised in vertical mergers is that the nature of competition, and therefore the equilibrium, will be dramatically changed. For example, there may be concerns that the terms for rival firms would change so significantly that a market will switch from competitive to monopolized. Vertical theories of harm can thus have a potentially existential effect on the affected firms (i.e., they may be forced to exit the market altogether). This may push such firms to look much more closely at their options than if prices moved by a small but significant amount of five to ten percent, as one would typically consider in the usual context of market definition.

Second, does the merging party in the related market have the **incentive** to see that ability used for the benefit of their merging party in the relevant market? To see the importance of this effect, consider the example in Box 3.

> ***Box 3:*** *Two wholesale suppliers, A and B, supply an input to manufacturers of a consumer product. The manufacturers' technology is specialized, so that it is compatible with the inputs of only one of the two suppliers. Suppose A merges with one of the manufacturers that it supplies (M). Wholesaler A could increase the price it charges to other manufacturers that it supplies. If switching to being supplied by B would be costly to those manufacturers, this may reduce the intensity of competition downstream. Wholesaler A may be more likely to have the incentive to engage in this conduct if the sales lost by these manufacturers are likely to switch to M. It may be less likely to have the incentive to engage in this conduct if lost sales are more likely to go to manufacturers that are supplied by wholesaler B. Wholesaler A may also have a greater incentive to consider such conduct the greater manufacturing margins are relative to wholesaler margins.*

It is tempting to assume that there is a generalizable and monotonic relationship between share in the relevant market and the magnitude of incentives. This might be true, but measuring the magnitude of the incentive to manipulate competition in a market will generally depend on facts specific to each case. Consider, for example, how the various incentives mentioned in Box 3 might be affected by M's share of the manufacturing market. A higher share might mean that sales lost by the competing manufacturers are more likely to switch to M. It might also mean that manufacturing margins are higher if M's share is a signal of how concentrated manufacturing is. Both of these suggest that the merged firm's incentives might be higher (relative to a situation where M's share is lower), but, a higher share for M could also mean that a greater portion of manufacturing margins are already being earned by the merged firm without any manipulation and therefore the merged firm's incentives to raise prices are low.

Third, is the nature of pre-merger **contractual limitations** such that above actions are only made possible as a result of the merger (i.e., merger-specific)?

For better or worse, a merger has an effect only because there are outcomes which cannot be reasonably achieved through contracts alone. The fact that a vertical merger has been proposed at all may suggest that there is some binding limit to what contracts can achieve in a specific case. Identifying what these limits really are will shape predictions about what outcomes are both likely post-merger and merger specific.

A common simplification in the economics literature is to assume that contracts can only have "linear pricing" – that an upstream firm can only charge a constant per-unit wholesale price to downstream firms. This linear-pricing restriction is an easy contractual constraint to incorporate into the math of an economic model. The draft guidelines should differentiate between contract features that are used in practice and those that are used in economic models for analytic convenience.[7]

Finally, what is the **net evaluation** of the merger? Vertical mergers create opportunities to achieve new outcomes by allowing new combinations of incentives and ability that might work in opposite directions.[8]

This final step asks whether at the end of the day, end consumers are likely to experience harm (as opposed to the pro-competitive harm competitors may feel from having to compete with a more efficient rival). It also asks, however, that the agencies establish some way to predict which of potentially alternate outcomes a merged entity is likely to pursue. Consider the example in Box 4.

> ***Box 4:*** *Assume that a vertical merger is proposed as a way to kick-start a new platform for exchange between participants in both of the merging firms' markets (a pro-competitive outcome). Further assume that this merger also creates an opportunity to foreclose rivals (an anti-competitive outcome). This leaves the agencies having to decide which set of outcomes is more likely than the other – working with rivals as a supplier or driving them from the market – even after proving that the latter would harm competition if it were to occur.*

Behavioral remedies are one vehicle for sorting between the possibilities of what a merged firm is likely to pursue. In the example in Box 4, the agencies could make the development of a new platform more likely by allowing the merged firm to offer commitments not to foreclose or disadvantage rivals. Admittedly, a concern is that it may be difficult to write a contract preventing something from happening when it was too difficult to write a contract to accomplish that outcome pre-merger. With current guidance from at least one agency discouraging behavioral remedies, the

[7] It is worth noting that, moving forward, the draft guidelines may also have an effect on how vertical conduct cases are litigated, just as the horizontal merger guidelines have played a role in horizontal conduct cases (for example, in setting the standard for market definition).

[8] Note that such a net evaluation would be necessary in circumstances where pro-competitive and anti-competitive effects impact the same relevant antitrust market. While we understand this to be a question of law, presumably the agencies would not balance pro-competitive effects in one relevant antitrust market with anti-competitive effects in a different relevant antitrust market, just as they and courts do not generally engage in such balancing in horizontal mergers.

question of how the agencies will sort between alternate paths remains an open one that the current draft guidelines do not address.

4. Market definition

The draft guidelines indicate that "the agencies will normally identify one or more relevant markets in which the merger may substantially lessen competition." They go on to explain that "when the agencies identify a potential competitive concern in a relevant market, they will also specify one or more related products." The implication of this is that a market for the related product need not be defined.

It is worth noting that other jurisdictions follow the convention of defining markets for both of the merging products.[9] Those jurisdictions have many other differences that may make the choice less impractical than it may be in the U.S., but it is worth considering their example in finalizing these guidelines.

Limiting the number of markets that will have to be formally defined before one gets to analyzing competitive effects is an understandably pragmatic approach. It is also consistent with the horizontal merger guidelines increasingly de-emphasizing the need for market definition. Indeed, defining the market for the related product potentially raises issues divorced from the analysis of the merger's competitive impact. The draft guidelines seem to avoid this by simply identifying the ability-laden product as the "related product" without defining a market around it. This might simplify the analysis but raises several issues.

First, the language is not particularly intuitive. A related product could be related in countless ways, and this labeling doesn't convey the idea that it needs to be a product that has ability to influence competition in the relevant market: one of the principles discussed in the previous section.

The related product is defined as "a product or service that is supplied by the merged firm, is vertically related to the products and services in the relevant market, and to which access by the merged firm's rivals affects competition in the relevant market." This rather convoluted definition is unlikely to be helpful for non-specialist readers.

[9] Davis, Hatzitaskos, and Majure (2020), at § 3.

Further, the draft guidelines' Example 1 is rather confusing as written, and unlikely to help those that are already struggling with the definition.[10]

Second, the draft guidelines do not discuss the evidence that would be required to identify a related product, nor do they articulate how to test that the related product has the potential to impose a meaningful change in competition in the relevant market. That is likely to be a more nuanced exercise than what is normally required to define a product market, and to rely more heavily on case-specific analysis rather than a generic toolkit. The draft guidelines provide no guidance on how the agencies will do that in practice.

Third, the lack of a market definition for the related product forces the agencies to offer the idea that its share can be measured indirectly through how often it is "used" in the relevant market. As a practical matter, the connection between various forms and measures of use and the purpose of share thresholds (discussed further in the next section) should be further spelled out to avoid some likely sources of confusion.

> **Measuring use:** For market shares, the horizontal merger guidelines note that revenue shares will generally be the preferred. One might assume that the agencies plan to establish which units in the relevant market incorporate the related product and take the revenue share of such products. Even assuming such a mapping is practical, it ignores the fact that the most interesting potential alternatives to the related product are likely also inputs used in many of the relevant market products. Consider a case where the related product is one of two inputs included in every product sold in the relevant market, and that the mix between these two inputs can be adjusted at small cost up to total reliance or replacement. Both of these products could be claimed to be used in 100 percent of the relevant market but, obviously, neither has the kind of power that 100 percent share would suggest. An alternative measure to address such a situation might assign relevant market sales in proportion to input costs as a share of all input costs, only to create an issue where the one product that is absolutely critical is discounted by the input costs of many competitively supplied other inputs. A measure of sales the related product is "used in" is really only well defined in the simple case where

[10] The example describes two potential relevant markets. It might work better if these two potential markets were broken into their own separate examples, each with some additional discussion that clarifies the difference between the two.

production is strictly 1-for-1, which will not be very helpful in many vertically related industries.

Complementary inputs: Some of the difficulty in establishing an appropriate way to measure usage share is due to the fact that share is not a well-defined concept among complementary inputs. If the whole notion of a chain of production is that products are combined into something more valuable than the sum of its parts, then what share in that value does each contribute? It is easy to conjure up hypothetical scenarios where this ambiguity leads to materially different conclusions. Consider a merger involving a media content provider upstream where, by some measure, the merging firm is just less than 20 percent of a typical MVPD service (e.g., the provider's content makes up 20 percent of the individual programs or minutes of use), but where its content is present in 100 percent of MVPD offerings. Or consider a patent holder with a technology that must be included in every cell phone, but the license to use its patents is only 10 percent of royalties paid by all participants in a prospective relevant market for cell phones.

Current use vs. potential for abuse: As mentioned above, pricing to an existential level may bring into play options outside those observed pre-merger. Conversely, a product may be widely used precisely because it has little value to add and is, therefore, priced only on the basis of competition with the next-best alternative. While the product enjoys high market share today, demand for the product is actually highly elastic and the firm does not have high market power (in this context, considering margins rather than market shares would tell us more about the merging firm's market power and hence, ability to influence the relevant market).

In short, avoiding a market definition for the related product forces a novel construction of shares for the safe harbor that risks becoming particularly decoupled from the purpose: to screen mergers where there is little or no potential for abuse.

As a final comment, the relegation of any details about the methodology for market definition to the horizontal guidelines means that the draft vertical guidelines are silent on elements of market definition specific to vertical mergers, in particular whether internal supply should be taken into consideration.[11]

[11] 1984 Merger Guidelines, https://www.justice.gov/archives/atr/1984-merger-guidelines.

5. Market share thresholds

The draft guidelines state that “the agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market.”

The draft guidelines and public comments from agency officials make clear that these thresholds are not offered as strict safe harbors: “In some circumstances, mergers with shares below the thresholds can give rise to competitive concerns. … The purpose of these thresholds is not to provide a rigid screen to separate competitively benign mergers from anticompetitive ones.” Nonetheless, if these thresholds did not convey something about when the agencies are likely to investigate, they would not be in the guidelines.

5.1. Threshold for the relevant market

In the context of the framework set out earlier in section 3, a 20 percent share in the relevant market does not seem to be a useful threshold. The “relevant market” generally represents the incentive side of a merger’s combination between incentives and ability. There is generally no simple relationship between high or low pre-merger shares in the relevant market and greater or lower incentives for post-merger manipulation.

Lacking any clear foundation in the general framework of vertical mergers, the 20 percent mark is prone to creative interpretations as a statement of how the agencies believe competition within markets ordinarily works. For example, the 20 percent threshold could be taken as a statement that the incentives of firms smaller than 20 percent are not relevant, because they cannot credibly expect to gain enough share, even with the backing of a firm with the ability to “affect[] competition in the relevant market.” Such a statement could be applied to horizontal mergers and dramatically change the landscape of merger guidance.

An alternative approach that could be taken in final guidelines is to replace this market share threshold with a statement that the agencies are unlikely to challenge a merger where either concentration or the potential to win business by manipulating competition is not significant, in the sense that it can generate materially different incentives for the merged firm from those of the unintegrated owner of the related product. A statement acknowledging this key element of a vertical case is more relevant and useful guidance than a safe harbor that may not be binding anyway.

5.2. Threshold for the related product

Aside from the issues of measurement discussed above, there is also a question of whether 20 percent of use in the relevant market is a reasonable threshold. Share in the related market is meant to measure the ability of the merged entity to engage in anticompetitive foreclosure. As stated above, the degree to which this share reflects ability depends heavily on what "used in" means.

For example, if this threshold was intended to mean that a safe harbor does not apply even if three of the four competitors in a relevant market have no current need for the related product (assuming equal sizes, this could be a use share of 25 percent), this threshold implies investigations in a lot of situations where there is no credible expectation that the related product conveys an ability to manipulate competition in the relevant market.

However, as long as the draft guidelines admit the ambiguities discussed above, it is difficult to imagine a higher safe harbor as an accurate predictor of which mergers the agencies will likely examine. In other words, a higher threshold invites even more abuse of the ready availability of misleading measures for how much a product is used in the relevant market. In the sense of two wrongs making a right, this threshold at least does not create as much of a problem as a higher threshold could.

Further, since vertical mergers involve a practical difficulty of forecasting outcomes far from those currently observed – i.e., how might markets react if a merged firm attempted to use a previously untapped ability to manipulate competition and, potentially even to threaten the existence of competitors – current use of the merging firm's related product may not perform well in capturing these effects. It seems more relevant to articulate the reasons or a rebuttable presumption based on a set of facts where that kind of power is likely to exist.

6. Double marginalization

As set out in the draft guidelines, one consequence of a vertical merger can be that downstream prices charged by the merged entity are reduced as a result of the elimination of double marginalization ("EDM").[12]

However, the draft guidelines seem to award EDM a special status, dedicating a separate section exclusively to this topic. The motivation for this is unclear. In our view, elimination of double marginalization should not, generally as a matter of economics, be treated any differently from other types of efficiency. One may argue that efficiencies as a whole may be more relevant in vertical mergers than in horizontal mergers, but they should still pass the test of merger-specificity regardless of their nature.

Double marginalization is present in models that assume linear pricing but need not arise in models with more general pricing contract arrangements. Specifically, we note that EDM may seem to be a necessary property of particular theories such as foreclosure or raising rivals' costs only because the economic models of those theories commonly assume linear pricing. However, both foreclosure and raising rivals' costs can occur in industries where contracting constraints do not generate double marginalization. It is therefore important that the guidelines distinguish between effects that are driven by common assumptions made in the academic literature and facts that are industry specific.

The draft guidelines do seem to recognize that some fact patterns will make EDM less relevant. However, positioning EDM as a separate section may lead to a disconnect between these fact patterns and the calculation of competitive effects to which they are relevant. This disconnect leads to a confusing situation where EDM is neither fully in the analysis that should include it, nor fully out of the analysis when it is not relevant.

As other contract restrictions may be the reason for a particular vertical merger, the guidelines' special treatment of EDM has to come with acknowledgement that its inclusion depends on the availability of contractual solutions absent the merger – if it can be achieved via contracts that are feasible, then it should not be counted as a pro-competitive effect of the merger. However, other efficiencies may be directly

[12] The name, Elimination of Double Marginalization, refers to the fact that the distorted pricing in the relevant market is the second (hence "double") decision of what margin to apply.

related to the contract restrictions in such a case and should have the prominence in that case that the draft guidelines reserve for EDM.

Conversely, where the facts of a case establish that the central constraint on pre-merger behavior is that only simple linear prices are possible, the language used in the draft guidelines undervalues the role that EDM plays. If an analysis of pricing indicates that the merged firm will raise rivals' costs because that is the only way the firm can extract their profits, it is appropriate to include EDM as part of the calculus for how the merged firm will price following the merger, and hence whether, overall, consumer prices will rise or fall. If anything, in this scenario, separating EDM from the rest of the modeling of price optimization is suggesting a distinction of effects that is misleading. In both cases, the merged firm is influencing profit margins of different participants in the relevant market, in order to tilt competition in its own favor.

7. Standards for merger review

7.1. Evidence to be presented

While the draft guidelines go some way to setting out the economic principles that will motivate how vertical mergers are reviewed, they are particularly thin in terms of providing details for how this will take place in practice.

In terms of methodologies the agencies are likely to employ when analyzing the competitive effects, a lot of the relevant guidance is left to a black box of merger simulation, with no discussion of the required data to populate such a model or the specific assumptions that will need to be considered. There is also no mention, for example, of pricing pressure indices (e.g., vGUPPIs), although we imagine that such models will be considered where sufficient data to construct a merger simulation model are not available.

There is also a noticeable lack of detail in terms of what fact patterns the agencies will consider to test any proposed theories of harm. The lack of detail regarding fact patterns matters because, as we discussed in our framework section, vertical mergers involve a wider set of competitive effects and require a more case-specific analysis. In this respect, the EU guidelines provide a much richer reference source for practitioners to work through their cases and understand where the issues are likely to lie. For example, in order to evaluate the ability of the related product to influence competition in the relevant market, the agencies are likely to consider the degree of product differentiation in the relevant market and how this depends on the related product, how high switching costs are, whether there are decreasing returns to scale in the relevant market, whether firms are capacity constrained, as well as potential counterstrategies available to rival firms (such as sponsoring entry or changing their product design to rely less heavily in the related product).

In this sense, if the goal is to provide clarity to anyone other than antitrust specialists already familiar with the review process for vertical mergers, the draft guidelines seem to fall short. Not being too abstract may be particularly important given the role of generalist judges in the U.S. merger review process.

7.2. Standards for challenging a merger

The draft guidelines also leave open some questions as to the overall standard that will be applied to conclude on whether a transaction should be challenged or not.

The analysis of vertical mergers is likely to involve judgements about firm behavior further away from current market conditions.

- The familiar tools for merger review, which look at small deviations close to an existing equilibrium, may not be as helpful when applied to mergers that enable something dramatically new. How will the review be adjusted (if at all), to deal with the potentially more speculative nature of the analysis in vertical settings?
- Can something be gleaned about the likelihood of anti-competitive strategies from the stated concern of rivals in the relevant market, given that they would also be disadvantaged by the merged entity becoming a more effective competitor? Beyond asking rivals themselves, how will the agencies evaluate theories of harm based on existential threats to these rivals and the extent to which these threats could be met with alternative responses?

Finally, it is not entirely clear how the agencies will weigh pro-competitive and anti-competitive effects to arrive at a view of the net effect of the merger. The conventional wisdom seems to be that vertical mergers are efficient, but this seems to be driven primarily by the fact that vertical integration is common. The draft guidelines appear to move away from any such presumption and embrace a more evidence-based approach. If that was intentional, the guidance should make a clear statement of the fact that economic theory offers no reason to presume, absent a review of the facts, that a vertical merger is likely to be either pro-competitive or anti-competitive.

The standard to meet for a merger not to be challenged is, presumably, that the merger does not "substantially lessen competition" through any anti-competitive strategies pursued by the merged entity, and net of the effects of any efficiencies and the elimination of double marginalization. This is very much left to be inferred by the reader, as the text itself mentions "substantial lessening of competition" only in relation to partial elements of the analysis (e.g. in relation to foreclosure or raising of rivals' costs, in isolation of any other competitive merger effects).[13]

In addition, there is some ambiguity in the following statement: "The magnitude of likely foreclosure or raising rivals' costs is not *de minimis* such that it would substantially lessen competition." This may lead some to conclude that "not *de minimis*" and "substantial" are meant synonymously. Is this the intention, or should "substantial" be interpreted to mean materially above zero? And is this meant to have any implications in terms of the results of any quantitative analysis? It is unclear whether this ambiguity in the draft guidelines is an intentional choice by the agencies, leaving themselves room to maneuver as different cases arise. While this may buy the agencies significant leeway, it means that again the guidelines fail to provide clarity for those making strategic decisions about whether to pursue a transaction.

[13] Draft guidelines, point (4) on p. 5.