# IS THERE A BETTER APPROACH TO VERTICAL MERGER ANALYSIS?

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The DOJ and FTC have lost a series of vertical merger cases over the past several years. One possible reason for these losses is the government's strategy – specifically, that there has been too much focus on the often technical details of models such as raising rivals' costs that have become standardized tools of vertical analysis. These tools can lead to an overly narrow way of viewing harms and a tendency to discount efficiencies in vertical mergers. As the economics literature has shown, vertical mergers can lead to a wide range of outcomes that can be difficult to translate into a simple analytical framework. The best way to identify the most likely possibilities (both pro- and anticompetitive) from this wide range of outcomes may be to start with predictions of industry participants, then to build evidence around the economic theories that are consistent with these predictions. This approach would require engaging with the efficiencies of vertical mergers, but we believe it empowers the agencies to do so with a more compelling alternate theory instead of a technical model. It is also truer to the economic literature's teaching of what all can follow from a vertical merger.

# I. INTRODUCTION

In 2017, the Antitrust Division of the US DOJ filed a challenge to the purely vertical merger[2] of AT&T with Time Warner that became the first such case to be fully litigated in 40 years. That challenge was unsuccessful, and it began a spate of similarly unsuccessful challenges to vertical mergers including the FTC's recent loss in its challenge to the merger of Tempur Sealy and Mattress Firm.

The lack of success in blocking vertical mergers could reflect a number of factors. It is possible, for example, that each of the litigated mergers was procompetitive and the agencies were mistaken in attempting to block them.[3] However, it is also possible that the agencies were correct that some (or all) of these mergers would likely harm competition, but the agencies' theory of competitive harm failed to resonate with the judge.

This latter possibility – that there has been a problem with the government's strategy – should be carefully considered. The agencies' approach to vertical cases has tended to rely on tools and theories that mirror tools that have been more effective in horizontal merger challenges. Perhaps the problem is that this has led to a too-narrow view of how competitive conditions change as a result of vertical mergers.

Essentially, these horizontal merger tools depend on mergers mainly changing the balance of already-existing factors that govern the outcomes we observe before a merger happens. That can contribute to a way of thinking of merger effects as scaling up or down these existing factors within the existing structure of a market – i.e. taking the ordinary responses we observe as the market reacts to small changes and scaling them up to the size of the merger. The approach also contributes to relegating merger efficiencies to a second stage question of whether the scale of efficiencies associated with a merged firm (operating in essentially the same market as before the merger) will likely offset competitive harm.[4]

Vertical effects, however, do not fit naturally into this approach of scaling incentives within the same market structure that exists without the merger. While a vertical merger can have an effect that amounts to scaling incentives, such as raising rivals' costs (RRC), and that particular effect might be well-addressed with tools that assume existing market conditions, a vertical merger can also fundamentally change market conditions by introducing a new type of structure—new forms of relationships between the merging parties and possibly between them and other firms in the market.

This sort of change to market conditions cannot be addressed with tools that change only the scale of particular factors within the given pre-merger market structure. So, approaches that have become standard and featured in these modern vertical merger challenges may fail for the same reason the horizontal merger tools often succeed: They are designed to address the sort of change in the balance of factors and the scale of incentives that happens in horizontal mergers and not the sort of change in the relationships themselves that are central to many vertical mergers. This can have the critical implication of reducing the courtroom positions to the government trying to narrow the judge's focus onto a technical model of marginal changes in incentives stacked against the parties' articulation of broad new possibilities enabled by the merger.

As an example, in the DOJ's challenge to the merger of AT&T and Time Warner, the DOJ argued that the combined firm could disadvantage competitors by raising the cost of Turner content, which it argued was an important component of cable TV bundles. This theory of harm does include a potentially offsetting efficiency of the same sort, elimination of double marginalization or EDM. But, both RRC and EDM assume that the merger can only affect the industry through one particular factor, the level of wholesale price, set in the same overall industry structure after the merger as before the merger; no other aspect of the relationships in the industry are allowed to change. The Court did not find the theory compelling, noting that the DOJ expert's economic model "runs contrary to all of the real-world testimony."[5]

This is not to suggest that RRC is not a valid part of the economics literature on vertical effects. It is. However, that literature also includes a wide range of other possibilities when firms merge vertically – with outcomes ranging from wildly anti-competitive to critical for fiercely enhanced competition depending on what aspects of the relationships between firms in the industry are allowed to change.

2 Although the 2023 Merger Guidelines recognize that it is the effects of a merger that are horizontal or vertical and recommend against categorizing mergers as one or the other, in this article for clarity we follow the still common practice of discussing mergers as one or the other based on what sort of effect is most relevant in the final analysis.

3 Wright & Rybnicek make this argument regarding the AT&T/Time Warner merger challenge. See United States v. AT&T/Time Warner: A Triumph of Economic Analysis by Joshua D. Wright, Jan Rybnicek :: SSRN.

4 This two-stage approach is even embodied in economic tools such as the compensating marginal cost reduction. See, e.g. Gregory J. Werden, "An Economic Perspective on the Analysis of Merger Efficiencies" (1997) *Antitrust* 11:3-12; Sonia Jaffe and E. Glen Weyl, "The First-Order Approach to Merger Analysis" (2013) *American Economic Journal: Microeconomics* 5 (4): 188-218.

5 *United Sates of America, Plaintiff, v. AT&T Inc., et al.*, Defendants, Memorandum Opinion, June 12, 2018, p.113.

In fact, one possible reason enforcement has adopted the horizontal-like tools may be that the wide range of outcomes identified in the economics literature does not translate easily into a simple and uniform framework. The tractability of limiting consideration only to marginal changes in a wholesale price – the restriction that underlies that RRC and EDM model – is also what allows tools such as vertical arithmetic and vGUPPIs to resemble horizontal tools. By eliminating the full range of potential outcomes, however, these tools have lost an important connection to what a vertical merger can do and to a lot of the economics literature in this area.

Economists are not alone in seeking to simplify this range of possibilities. Some scholars have read the literature as identifying vertical mergers with a presumption of pro-competitive effects while the 2023 Merger Guidelines seem to suggest the range of possible anti-competitive effects might all need to be disproven to overcome a de facto presumption against vertical mergers. What the seeming intractability of the economics literature teaches, however, is that both sorts of outcomes need to be considered. The facts of a case, rather than some standard assumption, need to guide the analysis so that in each case the most credible pro-competitive possibility can be weighed against the most credible anti-competitive possibility to evaluate the likely effect of that vertical merger.

## II. CHANGES IN TYPE vs CHANGES IN DEGREE: HOW VERTICAL DIFFERS FROM HORIZONTAL

Both horizontal and vertical mergers can involve substantial changes from the status quo that would not be considered marginal in economic terms. However, unlike predictions in vertical mergers, the predictions for a horizontal merger's effect are generally just a matter of degree – scaling up the marginal analysis to the merger's overall effect and then scaling that effect back down to the extent that efficiencies offset the marginal incentives. In vertical mergers, by contrast, the question is not merely one of degree but goes to the type and direction of changes to market structure that are enabled by the merger. So, where marginal analyses of horizontal mergers often capture both the most likely theories of harm and the impact of likely efficiencies, marginal analyses of vertical mergers do not.

To see this difference, it helps to consider what happens in a typical horizontal merger analysis. In the typical analysis of a horizontal merger, one tries to estimate how much pre-merger prices (or other competitive dimensions) are a result of the feedback from competitive alternatives that will be brought under common ownership. A marginal analysis asks, if the price of an acquiring firm's product were slightly higher (or lower), how much of its sales would be lost to (or gained from) the target firm's product. This is instructive about what is likely to happen in a merger because a horizontal merger generally tweaks the incentives of the merging parties in a way that might be very similar to ordinary adjustments firms make due to cost changes or other reasons – the types of changes captured by marginal analyses.[6]

This similarity in horizontal mergers between marginal analysis of merger effects and ordinary course adjustments also means that the companies' internal analyses, their prior decision making, and their executives' individual experience are all likely to include events that reflect the same sort of response to incremental changes that the merger implements. This means that the predictions of a marginal analysis can be compared to the companies' own past behavior and internal analyses. Abstracting from a lot of facts specific to each case, merger challenges are most compelling when these sources of evidence all line up with the economic analysis and when the economic analysis can predict effects that are well grounded in these fundamentally-similar fluctuations. Likewise, the defense of a merger is most effective when this same evidence shows that the merging parties are not a uniquely important determinant of each other's pre-merger prices or when it shows that efficiencies of the merger will offset any loss of that constraint.

Similar to the approach in horizontal mergers, marginal analyses of vertical mergers also presume that the post-merger world will not be too dissimilar from pre-merger circumstances. For example, vertical arithmetic asks whether, if the upstream component of the combined firm ceased selling to a downstream competitor, lost upstream profits would be compensated for by diversion to its downstream component from its foreclosed competitors. While that concept can theoretically be applied to any post-merger scenario, in practice this type of analysis is generally performed by taking the pre-merger market structure as a given and evaluating the question as if only the recipient of profits will change with the merger. Notably, this analysis is equivalent to asking whether one of the firms would have been willing to pay enough, pre-merger, to get an exclusive arrangement – but without looking at why that arrangement becomes more feasible after the merger (and without exploring if that reason, whatever it is, also makes new efficient arrangements feasible).

Assessing vertical mergers via marginal analyses does allow one to address one combination of potential harms and efficiencies that can occur in vertical mergers: that a particular change in the set of feasible outcomes implies both an incentive to raise input prices to customer competitors (capturing more share of the downstream sales) and another to lower prices (coordinating on a more efficient level of industry-wide

6 While this is generally the case for horizontal mergers, it is not universal. For example, a horizontal merger might involve the discontinuation of a product, which may not be approximated well by a marginal analysis. A recent example is the attempted merger of JetBlue and Spirit, where the Court noted that JetBlue intended to convert Spirit's planes to JetBlue's configurations and to move Spirit to JetBlue's pricing.

sales). But the analysis typically imposes that these marginal effects are the only possible changes and therefore misses bigger-picture questions such as the possibility that a new relationship between upstream and downstream might enable a fundamentally different downstream product.

The problem is that vertical merger effects can change competitive constraints in ways not captured by typical marginal analyses. Instead, they can transform what can be achieved in the business relationship – when the firms become one entity, they are no longer constrained by the issues between firms that cannot be effectively addressed contractually in their industry. These issues could include pricing constraints that lead to double marginalization. And, where that is the main change, the post-merger world might happen to be simply a matter of scale relative to this marginal analysis. But the issues a merger resolves could also include a number of other possibilities as well – possibilities that open up a range of new outcomes (good or bad) that would be more appropriate for the Court to consider. Analyzing a vertical merger, then, requires that we consider how the set of things that can be
achieved between the merging parties is changed.

## III. HOW TO BALANCE MARGINAL ANALYSIS, EVIDENCE, AND THE WIDER ECONOMIC LITERATURE IN VERTICAL MERGERS

If the marginal framework and its associated analyses cannot capture theories of harm outside of RRC and benefits outside of EDM, then how does one engage with these other possible combinations of harm and benefits? Perhaps the most important starting point is that the key to a vertical merger changing anything is that it relaxes constraints on what can be achieved by contract – opening up possibilities to reconcile both parties' previously-independent incentives in ways they lacked the ability to pursue together contractually. One can reasonably assume that the parties anticipate some change in constraints, as there would otherwise be no reason (good or bad) to merge. So, one can begin by understanding what currently cannot be achieved contractually. Some fairly typical examples come out of law and economics. For example:

You generally cannot write a contract paying a critical supplier to force a competitor out of the market.

It is also typically difficult to contract for a fair split of the unknowable rents of a new product that cannot exist without cooperation without some mutual ownership interests.
It may be similarly difficult to induce a trading partner to alter their business model in a way that makes your own firm's investments more likely to be profitable.

However, as the wide range of theoretical possibilities in the wider economics literature makes clear, simply identifying possibilities for the contractual change is likely to lead to a plethora of potential outcomes. One wants to keep this exercise grounded in the evidence as much as possible. Help in grounding the exercise and narrowing the set of possibilities for which one needs to gather evidence can often come from another source: the predictions of businesspeople (both the merging parties and their competitors).

In almost any vertical merger investigation industry participants typically have clear, though often conflicting, predictions of how the merger will transform their industry. Businesspeople at the merging firms and at their customer-competitors are rarely considering the wide range of theoretically possible outcomes, but instead have a hope or a fear of specific possibilities regarding how the merger will transform their firm and the industry. Taking these as the set of outcomes to evaluate, economists can focus in each case on identifying those parameters that can be estimated pre-transformation and that help us distinguish among the specific predictions in that case to assess if the one outcome most likely to be pursued is a transformation that enhances or impairs competition.

With the predictions of interested businesspeople as a starting point, one could then ask, e.g.:

- Are there changes to the relationship that parties have tried to effectuate and failed? Was that failure because of limitations that a merger would change or because the expectations of the possibility were proven incorrect?
- Are there expectations that businesspeople have about how they would act if they had control of the acquired firm? Do those expectations reflect whatever constraints (including incentives to do something else that is more profitable) that the firm itself sees with the possible action?
- Is there some history of relationships taking a different form (possibly before some change in regulatory environment or before competition developed in some part of the relationship) that gives particular credence to one set of possibilities as likely to be seen again?

Once possibilities have been identified, the marginal vertical analyses can be useful as a test of their feasibility. However, it is important to understand that this is an exercise akin to looking for the tallest mountain top with a tool that only tells you if you are heading uphill. A marginal tool like vGUPPI, for example, can confirm that you are not already at the top of a hill (that there is an incentive to move in a particular direction, to put this in vertical merger terms) and that going in a given direction will get you closer to a hilltop (that the ability implicit in a particular contracting limitation is plausible). However, without a lot more work, it cannot distinguish whether the profits from pursuing some merger-enabled anti-competitive strategy would be greater or less than the profits from climbing a different hill (going in a more pro-competitive direction by working on a more efficient relationship) that might lead to the highest of all possible hilltops. In that sense, the marginal tools are a useful piece of the process when they do not become the whole focus of the analysis.

Ultimately, the analysis needs to include some comparison of a careful selection among the most likely scenarios. To the extent that there is a dispute about whether the merger enables a more pro-competitive relationship or enables anti-competitive outcomes, it is plausible that a vertical merger enables both as possibilities. A merger can relax more than one limitation on what can be done contractually, after all. Ultimately, however, the firm can only choose one of the possible directions, so one has to use all of the available evidence to determine which direction is more likely.

That brings us back to the interpretation of the wider economics literature. We submit that this literature is not a prediction that anything can happen. Rather, it is useful for identifying how specific contractual constraints, in the presence of specific facts about the relevant markets, can make for particularly profitable opportunities. Given that the exercise involves some comparison of transformed markets well outside the scope of ordinary fluctuations in the existing market structure, both the pro- and anti-competitive possibilities need to be consistently recognized as applying the same body of theories to the parameters we can estimate (to the extent the experiences around the current equilibrium allow) and from some marginal analyses that can help select the right possibilities, but do not give the final answer themselves.

We suggest that first narrowing the possible outcomes using the predictions of industry participants and then building evidence around a framework of comparison based on economic theories consistent with these predictions is more useful and understandable to a Court. Often, such an exercise will not involve formal implementation of an economic model. Instead, it may involve an intuitive explanation of the model's structure, combined with an examination of qualitative and quantitative evidence to determine whether the model fits the facts. The model can also help in avoiding inconsistencies between claims of competitive effects (or their absence) and claims of efficiencies, which sometimes require opposing model assumptions.

The exercise a Court faces in a vertical merger is unfamiliar as it asks for a judgement between two groups' predictions of what the industry will look like after the transformation. Courts tend to be uncomfortable with speculation and this exercise can appear to be all about choosing one speculation over another. Economists trying to stretch tools designed to simplify their own problem have not proven to make this exercise more comfortable or easier for Courts. We hope economists can make the Court's choice less subjective by focusing instead on the facts that support or rebut each prediction.