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Supplemental Comments for Improving Guideline 6 of the 2023 Draft Merger Guidelines

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Guideline 6 of the Draft Merger Guidelines (DMGs) proposes structural evidence to satisfy the Agencies' *prima facie* burden for a vertical merger.[1] Applied to input foreclosure, structural evidence can provide a sufficient "probabilistic inference" of ability and incentive to engage in a foreclosure strategy that raises the costs or otherwise disadvantages downstream rivals that purchase the input brand sold by the upstream merging firm and thereby raises a substantial risk of lessening competition in the downstream market and harming customers. My previous comments[2] suggested revising the Agencies' required structural evidence for satisfying their *prima facie* burden in the case of input foreclosure concerns under Guideline 6 by specifying two prongs:

> (1) the merging firm controls a 50% (or more) foreclosure share for the input; and
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> (2) the input supplied by the merging firm is "critical" to downstream rivals in the sense that elimination of access or worsened terms would place them at a material competitive disadvantage that could lead to competitive harm to customers of the downstream firms.

This foreclosure share is measured by the share of the downstream rivals' input purchases from the upstream merging firm's input brand. For convenience, this comment refers to the rivals that purchase the input from the upstream merging firm as the "foreclosable" rivals. The foreclosure share is a rough proxy measure of the upstream merging firm's market power over the foreclosable rivals.[3]

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[1] As explained in DMGs' footnote 52, "In addition to this structural analysis, many vertical mergers can also be analyzed under the ability and incentive analysis in Guideline 5. Either can be a sufficient basis to warrant concern."

[2] Steven C. Salop, *Some Comments for Improving the 2023 Draft Merger Guidelines* (September 12, 2023), https://www.regulations.gov/comment/FTC-2023-0043-1364.

[3] For example, a foreclosure share of 50% (or higher) suggests that an input price increase by the upstream merging firm commonly would lead to only limited substitution, such that the costs of the foreclosable rivals would increase. The exact upward pricing pressure could be larger or smaller. On the one hand, pricing pressure could be larger because competing upstream merging firms may accommodate the price increase by raising their own prices in response, for example, if the inputs are differentiated and/or there is substantial upstream market concentration. On the other hand, it could be smaller if the firm was "limit pricing" out of fear of substantial potential entry or vertical integration by the foreclosed rivals if it raised its input price. While defining a relevant input market may not be formally required, one

Prong 1 is focused on the ability to foreclose.[4] On further analysis, the structural evidence supporting a probabilistic inference of lessened competition might be refined and improved by also including a third prong to the *prima facie* burden that is focused on the incentive to foreclose. This evidence would relate to the potential impact of foreclosure on downstream competition. This supplemental comment considers two variants of this additional structural evidence.

One possible version of the third prong would be the following:

> 3a. A hypothetical merger of the downstream merging firm and all the foreclosable rivals would violate the concentration and market share thresholds of Guideline 1.

The rationale for prong 3a is that the upstream merging firm's indirect control over the prices of the foreclosable rivals' (resulting from its ability to raise their costs) is similar to the impact of a merger between the downstream merging firm and these foreclosable rivals. This version of the third prong has the advantage of being intuitive. Its connection to Guideline 1 also makes it appealing.

However, this third prong can be improved with a small increase in complexity. The formal analysis in a recent article by Moresi & Salop[5] showed that the structural analogue to the impact of input foreclosure on the downstream market HHI is not exactly the same as such a merger. The upstream merging firm's ability to raise their costs by raising its input price gives it only partial control over the downstream prices charged by the foreclosable rivals. This partial control leads to upward pricing pressure ("UPP") on the downstream prices charged by the foreclosable rivals. But, because a foreclosure strategy gives the upstream merging firm less than total control over the foreclosable firms, the impact is less than what would occur from a full merger of the downstream merging firm and the foreclosable rivals.[6]

This analysis, and the implied alternative prong 3b described below, translates this UPP into the effect on a modified HHI ("mHHI").[7] This mHHI is derived from set of a hypothetical transactions in which the foreclosable rivals gain passive partial ownership shares in the downstream vertical merging firm, which leads them to have incentives to raise their prices.

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can think generally of an implicit market as a "targeted customer" (price discrimination) market comprised of the foreclosable rivals of the downstream merging firm.

[4] Prong 2 is connected to the magnitude of the potential harm to the foreclosable rivals that can be related to both ability and incentive.

[5] Serge Moresi and Steven C. Salop, *When Vertical is Horizontal: How Vertical Mergers Lead to Increases in "Effective Concentration,* 59 REV. IND. ORG. 177 (2021), [When Vertical is Horizontal: How Vertical Mergers Lead to Increases in "Effective Concentration" | SpringerLink]. An earlier version of this article was submitted as a comment on the draft of the 2020 Vertical Merger Guidelines.

[6] A full merger also would lead to an incentive to raise the price of the downstream vertical merging firm.

[7] The Moresi & Salop article used the modified HHI. It did not use the combined market share at all.

This set of hypothetical transactions leads to the same mHHI effect as would a hypothetical transaction in which the downstream vertical merging firm gains passive partial ownership shares in all the foreclosable rivals. The analysis of the UPP and mHHI demonstrates that the relevant partial ownership shares are equal to the cost pass-through rate of the upstream merging firm. Economists often assume a pass-through rate of 50% as a first approximation, which can be incorporated into the third prong.

This approach leads to the following improved form for the third prong:

> 3b. A hypothetical acquisition by the downstream merging firm of a 50% passive ownership interest in all the foreclosable rivals would violate the concentration thresholds of Guideline 1 (i.e., post-merger mHHI > 1800; delta mHHI > 100).

The delta mHHI is closely related to the standard merger HHI. This delta mHHI is 50% *times* the product of the shares of the downstream vertical merger partner and all the foreclosable firms.[8] The post-merger mHHI is equal to the pre-merger HHI *plus* 50% *times* the product of the shares of the downstream vertical merging firm and the foreclosable rivals. (The analysis of Guideline 12 would utilize these mHHIs, so they do not create a major new analytic complexity for staff, counsel, or courts.)

Comparing prongs 3a and 3b, prong 3b has the disadvantage of not simply applying Guideline 1 as is. But it has the offsetting advantage of being derived from a relevant economic model. Thus, it is not vulnerable to the likely criticism of version 3a that the impact of the foreclosure on the behavior of the foreclosable rivals would not be identical to their behavior after being acquired by the downstream merging firm.

The Moresi & Salop article also includes an mHHI that accounts for the separate incentive to raise the price of the downstream merging firm. This effect is the so-called Chen effect and occurs even if there is no foreclosure incentive. However, rather than take this Chen effect into account in the structural evidence, it alternatively can be accounted for as an "opportunity cost" of passing-through EDM as lower prices, an opportunity cost that mitigates or even reverses any downward pricing pressure from merger-specific EDM.

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To conclude, the required structural evidence to satisfy Guideline 6 can be comprised of prongs 1, 2 and 3b. Guideline 6 would treat this evidence as sufficient to satisfy the Agencies' *prima facie* burden and shift the burden to the merging parties to rebut the anticompetitive inference created by this structural evidence.

The cognizable rebuttal evidence then would include evidence of "EDM pass-through" (i.e., downward pricing pressure after taking account of the opportunity cost/Chen effect and downward pricing responses by downstream competitors), other cost and quality efficiencies,

[8] By contrast, the full merger delta HHI is *twice* the product of the shares of the downstream vertical merger partner and all the foreclosable firms, instead of *50%* of the product of the shares.

and the usual possible rebuttals involving entry, intense competition from upstream competitors or non-foreclosed rivals, rival counterstrategies and so on.