

The Federal Trade Commission’s Hearings on Competition and Consumer Protection in the 21st Century, Vertical Mergers, Comment of the Global Antitrust Institute, Antonin Scalia Law School, George Mason University

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This Comment is submitted for consideration in relation to the Federal Trade Commission’s (“FTC”) Hearings on Competition and Consumer Protection in the 21st Century. We submit this Comment based upon our extensive experience and expertise in antitrust law and economics.¹ As an organization committed to promoting sound economic analysis as the foundation of antitrust enforcement and competition policy, the Global Antitrust Institute commends the FTC for holding these hearings and for inviting discussion concerning a range of important topics.

In this Comment, we discuss the economic analysis of vertical mergers; the existing and updated empirical evidence on their competitive effects; and, ultimately,

¹ 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, Associate Professor of Law at Scalia Law, and former Acting Deputy Assistant Director in the Bureau of Economics, Antitrust Division, at the 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 substantial assistance in the preparation of this Comment provided by Scalia Law student Anora Wang.

whether a revision to the 1984 *Non-Horizontal Merger Guidelines* is desirable as a matter of antitrust policy.² First, we find continued support for the conclusion that vertical mergers and contractual restraints are generally procompetitive or competitively neutral.³ In regard to revised guidelines, we offer a number of observations that we hope add to the discussion—but ultimately question whether there is sufficient legal uncertainty to warrant a revision and whether updated guidelines would adequately, and properly, address that uncertainty.⁴

Distinguishing Vertical and Horizontal Mergers

Since the work of Ronald Coase (1937), and subsequent work by Oliver Williamson (1971, 1979, 1983), Benjamin Klein (1978, 1997, 2000), and others, economists have developed a better understanding of the nature of firms, the transactions that occur within firms, how firms interact with the larger market, and efficiency rationales for vertical integration.⁵ Later theoretical work has developed potentially

² See U.S. DEP'T OF JUSTICE, *NON-HORIZONTAL MERGER GUIDELINES* (1984) [hereinafter, 1984 VERTICAL MERGER GUIDELINES], www.justice.gov/atr/public/guidelines/2614.pdf.

³ For the prior empirical evidence, see Francine Lafontaine & Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence*, 45 J. ECON. LITERATURE 629 (2007); James C. Cooper *et al.*, *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639 (2005).

⁴ See Greg Werden, *Should the Agencies Issue New Merger Guidelines?*, 16 GEO. MASON L. REV. 839 (2009).

⁵ 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); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. & ECON.* 233 (1979); Oliver E. Williamson (1983), *Credible Commitments: Using Hostages to Support Exchange*, 73 *AM. ECON. REV.* 519 (1983); Benjamin Klein *et al.*, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 *J.L. & ECON.* 297 (1978); Benjamin Klein & Kevin M. Murphy, *Vertical Integration as a Self-Enforcing Contractual Arrangement*, 87 *AM. ECON. REV.* 415 (1997); Benjamin Klein, *Fisher—General Motors and the Nature of the Firm*, 43 *J.L. & ECON.* 105 (2000). See also Joseph J. Spengler, *Vertical Integration and Antitrust Policy*, 58 *J. POL. ECON.* 347 (1950); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of*

anticompetitive rationales for vertical integration.⁶ Taken together, however, the theoretical literature, without empirical grounding, leaves practitioners, agencies, and courts with ambiguous guidance on the welfare consequences of vertical mergers.⁷ This ambiguity is fundamentally driven by the fact that (a) vertical mergers do not involve direct competitors;⁸ (b) efficiencies, such as the elimination of double marginalization, are absolutely central to the welfare assessment of vertical mergers—and cannot be treated as a “second step” or second order concern, as they occasionally are in the assessment of the welfare effects of horizontal mergers; yet (c) there is a concern that vertical integrated firms will increase incentives for the post-merger firm to foreclose competitors.

In contrast, 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—

Ownership: A Theory of Vertical and Lateral Integration, 94 J. POL. ECON. 691 (1985). For a summary of the literature, see Timothy Bresnahan & Jonathan Levin, *Vertical Integration and Market Structure*, in HANDBOOK OF ORGANIZATIONAL ECONOMICS (Robert Gibbons & John Roberts eds. 2012).

⁶ See, e.g., Michael A. Salinger, *Vertical Mergers and Market Foreclosure*, 103 Q.J. ECON. 345 (1988); Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209 (1986).

⁷ See David Reiffen & Michael Vita, *Is There New Thinking on Vertical Mergers?*, 63 ANTITRUST L.J. 917 (1995). Scholars have developed vertical arithmetic models, but a consensus has yet to emerge on the value of these tools for practitioners.

⁸ Of course, a merger can have both a vertical and horizontal component.

including merger simulations and, more recently, GUPPIs.⁹ Stated somewhat differently, absent efficiencies, entry, and 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.¹⁰

Because of this theoretical ambiguity for vertical mergers, empirically evaluating the welfare effects of consummated mergers has been and remains an important area of research for guiding antitrust policy. As Lafontaine and Slade (2007) state, empirically evaluating vertical mergers allows us to address “what are the consequences of vertical integration for economic outcomes such as prices, quantities, investment, and profits?”¹¹ These questions are “important ultimately as input into the development of sensible vertical merger policy and related government intervention in vertical relationships.”¹² Similarly, Wright (2012) proposes a move to “evidence-based antitrust,” which is “a

⁹ GUPPI is an acronym for “Gross Upward Pricing Pressure Index,” which is intended to conceptualize the unilateral effects from mergers on prices from the loss of a rival before adjusting for the effects of entry and efficiencies that put downward pressure on prices. See Steven C. Salop & Serge Moresi, *Updating the Merger Guidelines: Comments (Public Comment to Horizontal Merger Guidelines Review Project Nov. 2009)*, https://www.ftc.gov/sites/default/files/documents/public_comments/horizontal-merger-guidelines-review-project-545095-00032/545095-00032.pdf.

¹⁰ See Joseph Farrell & Carl Shapiro, *Horizontal Mergers: An Equilibrium Analysis*, 80 AM. ECON. REV. 107 (1990).

¹¹ Lafontaine & Slade, *supra* note 3, at 629-30.

¹² *Id.* at 630.

commitment to testing economic theories with economic knowledge and empirical data to support those theories with the best predictive power.”¹³

Empirical Evidence on the Competitive Effects of Vertical Mergers

The two most widely cited economic studies that summarize the empirical evidence on vertical integration are Lafontaine & Slade (2007) and Cooper *et al.* (2005).¹⁴ These authors are high quality industrial organization economists in competition agencies and academia. After comprehensively reviewing prior vertical integration research, Lafontaine & Slade conclude: “[C]onsistent with the large set of efficiency motives for vertical mergers that we have described so far, the evidence on the consequences of vertical mergers suggests that consumers mostly benefit from mergers that firms undertake voluntarily.”¹⁵ Similarly, Cooper *et al.* state: “Overall, we would characterize the empirical literature on vertical restraints/vertical integration as follows: Most studies find evidence that vertical restraints/vertical integration are procompetitive.”¹⁶ Finally 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

¹³ Joshua D. Wright, *Abandoning Antitrust’s Chicago Obsession: The Case for Evidence-Based Antitrust*, 78 ANTITRUST L.J. 241, 242 (2012).

¹⁴ Lafontaine & Slade, *supra* note 3; Cooper *et al.*, *supra* note 3.

¹⁵ Lafontaine & Slade, *supra* note 3, at 663.

¹⁶ Cooper *et al.*, *supra* note 3, at 658.

exceptions, the literature does not support the view that these practices are used for anticompetitive reasons.”¹⁷

The evidence they summarize remains valuable and should be considered in every discussion regarding vertical mergers. However, we believe a detailed, updated study that summarizes the empirical literature since 2008 would also be of immense value in guiding present and future discussions of vertical merger policy. While this Comment is not a substitute for that comprehensive study, we examine published research in peer-reviewed journals since 2008 that empirically analyzed the welfare consequences of vertical mergers in the U.S.

We used the following search criteria on EconLit (supplemented with a general web search) to identify relevant papers: Empirical studies published in peer-reviewed journals after 2008 that examine the welfare consequences of vertical integration in the U.S. It is likely that the set of papers we examine is not exhaustive; thus, we consider it only as a snapshot of the likely larger empirical literature. Nonetheless, we believe it offers valuable updated evidence on the state of the empirical literature.

The table below summarizes the set of papers we examined.¹⁸ Of the thirteen papers examined, we can directly or indirectly infer the welfare effects identified by the

¹⁷ Daniel O’Brien, *The Antitrust Treatment of Vertical Restraint: Beyond the Possibility Theorems*, in REPORT: THE PROS AND CONS OF VERTICAL RESTRAINTS 40, 76 (2008), <http://www.konkurrensverket.se/globalassets/english/research/report-the-pros-and-cons-of-vertical-restraints-18mb.pdf>.

¹⁸ 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

authors as a result of vertical integration in eleven of them. Of these eleven, six had results that indicated vertical integration resulted in positive welfare changes; four had results with either no change, a mixed change, or no economically meaningful change in welfare; and only one (and perhaps two) had results that are consistent with a negative impact. The results are summarized in the table below.

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); Orley C. Ashenfelter *et al.* (2015), *Efficiencies Brewed: Pricing and Consolidation in the US Beer Industry*, 46 RAND J. ECON. 328 (2015); 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. i143 (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. Crawford *et al.*, *The Welfare Effects of Vertical Integration in Multichannel Television Markets*, 86 ECONOMETRICA 891 (2018).

Table: The Welfare Effects of Vertical Integration

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
Ashenfelter <i>et al.</i>	2015	Beer	Panel; Event Study	Price	no change	no change
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	-	+

In sum, these papers from 2009-2018 continue to support the conclusions from Lafontaine & Slade (2007) and Cooper *et al.* (2005) that consumers mostly benefit from vertical integration. 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.

Vertical Merger Guidelines

One important policy debate in antitrust is whether to update the largely defunct U.S. Department of Justice's 1984 *Non-Horizontal Merger Guidelines*.¹⁹ There are strong proponents for²⁰ and against²¹ issuing a revision. Regardless of one's view, it is certainly true that our understanding of vertical mergers, both theoretical and empirical, has grown significantly over the past 35 years.

Additionally, to some observers, it is striking that the *Horizontal Merger Guidelines* have undergone three major revisions since 1984, *i.e.*, in 1992, 1997, and 2010, while the vertical merger guidelines have remain unchanged.²² Thus, some argue, given the widespread use and adoption of the horizontal merger guidelines, the vertical merger guidelines should also be revised.²³ Ultimately, whether updated guidelines would be

¹⁹ Technically, the vertical merger guidelines are Section 4 of the DOJ's 1984 Merger Guidelines. See U.S. DEPARTMENT OF JUSTICE MERGER GUIDELINES (Jun. 14, 1984), <https://www.justice.gov/sites/default/files/atr/legacy/2007/07/11/11249.pdf>.

²⁰ See, *e.g.*, James Langenfeld, *The Need to Revise the U.S. Non-Horizontal Merger Guidelines*, 4 CONCURRENTS 51 (2010); Steven C. Salop & Daniel P. Culley, *Revising the US Vertical Merger Guidelines: Policy Issues and an Interim Guide for Practitioners*, 4 J. ANTITRUST ENFORCEMENT 1 (2016); Steven C. Salop, *Invigorating Vertical Merger Enforcement*, 127 YALE L.J. 1962 (2018).

²¹ See, *e.g.*, Paul Yde, *Non-Horizontal Merger Guidelines: A Solution in Search of a Problem*, 22 ANTITRUST 74 (2007); Werden, *supra* note 4.

²² For a history of the evolution of the merger guidelines, see Werden, *supra* note 4.

²³ This is further supported by the fact that the EU instituted vertical merger guidelines in 2008, see GUIDELINES ON THE ASSESSMENT OF NON-HORIZONTAL MERGERS UNDER THE COUNCIL REGULATION ON THE CONTROL OF CONCENTRATIONS BETWEEN UNDERTAKINGS (2008/C 265/07). For a discussion of the EU guidelines and whether there is a need to revise the U.S. guidelines, see Deborah L. Feinstein, *Are the Vertical Merger Guidelines Ripe for Revision?*, 24 ANTITRUST 5 (2010).

beneficial to practitioners, regulators, and the courts depends precisely upon what would be in such a set of guidelines. In this section, we offer a number of observations that we hope add to the discussion of the proper role of vertical merger guidelines.

First, it is worth noting that the horizontal merger guidelines have a spillover effect to vertical merger analysis. Both types of mergers share the basic steps of defining the relevant product and geographic markets and calculating market shares. Both types share the need to assess competitive effects based upon weighing evidence from the merging parties, market participants and, ideally, empirical analysis. Both types could involve unilateral and/or coordinated effects; both share the need to assess entry and efficiencies. Finally, both types could involve a theory of foreclosure or exclusion, which the horizontal merger guidelines address to some degree.²⁴ These conceptual overlaps reduce the need for a separate set of vertical merger guidelines.²⁵

Second, while we believe there is a reasonable level of agreement among economists and enforcers in applying the appropriate analytical framework to analyze vertical mergers, that level of agreement is almost certainly less than that found in

²⁴ See, e.g., U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES (2010), §1 ("Enhanced market power may also make it more likely that the merged entity can profitably and effectively engage in exclusionary conduct"), <https://www.justice.gov/atr/horizontal-merger-guidelines-08192010>.

²⁵ This notion of a spillover is consistent with the legacy of the 1984 Vertical Merger Guidelines—they were inserted (as "Section 4") along with the 1984 Horizontal Merger Guidelines to form the larger 1984 Merger Guidelines.

assessing horizontal mergers.²⁶ There is greater substantive divergence within the U.S. with respect to the analysis of unilateral conduct generally, as observed most prominently with the Antitrust Division's experience with the 2008 Section 2 Report and its ultimate withdrawal.²⁷ The lack of consensus on specific applications when it comes to vertical economic relationships suggests that successful guidelines should be limited to articulating high-level concepts and an overarching framework.

Third, one must also ask whether the lack of updates is due to a lack of demand, reflecting a lack of uncertainty in the law. Since 2000, the FTC and the DOJ have challenged approximately one vertical merger per year.²⁸ Furthermore, as is often cited, the DOJ's recent challenge of the AT&T-Time Warner acquisition was the first vertical merger challenge that went to court in forty years. These numbers raise a real question as to whether there would be sufficient value in generating and publishing updated

²⁶ Even proponents of issuing revised guidelines acknowledge the potential difficulty in finding a consensus. See Langenfeld, *supra* note 20, at 57 ("There are some legitimate questions about whether antitrust analysis and economics are up to the challenge of providing clear guidance for new Non-Horizontal Merger Guidelines").

²⁷ See FED. TRADE COMM'N, FTC COMMISSIONERS REACT TO DEPARTMENT OF JUSTICE REPORT, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT (Sept. 8, 2008), <https://www.ftc.gov/news-events/press-releases/2008/09/ftc-commissioners-react-department-justice-report-competition-and>. There is an analogous episode in which Assistant Attorney General Anne Bingaman, in a speech, rescinded the DOJ's 1985 Vertical Restraints Guidelines, see Anne K. Bingaman, Ass't Att'y Gen., Antitrust Div'n, *Antitrust Enforcement: Some Initial Thoughts and Actions, Address Before the ABA Section of Antitrust Law*, at 5 (Aug. 10, 1993) (explaining that the Vertical Restraints Guidelines "unduly elevate theory at the expense of factual analysis" and fail to reflect an optimal balancing of procompetitive and anticompetitive effects).

²⁸ See D. Bruce Hoffman, Acting Director, Fed. Trade Comm'n, *Remarks at Credit Suisse 2018 Washington Perspectives Conference: Vertical Merger Enforcement at the FTC* (Jan. 10, 2018) 1, https://www.ftc.gov/system/files/documents/public_statements/1304213/hoffman_vertical_merger_speech_final.pdf.

guidelines—particularly given the spillover effects from the horizontal merger guidelines.

The value of guidelines depends at least in part on whether one believes either: (1) practitioners do not understand how agencies are evaluating vertical mergers; or (2) courts are unable to understand the high-level concepts and framework. We have serious doubts that either of these beliefs is justified. For instance, the district court’s AT&T decision was not about high-level concepts, but very specific questions regarding the inputs and assumptions used in a particular type of model.²⁹

Conclusion

We find that recent empirical evidence continues to support the proposition that vertical integration generates abundant efficiencies and is generally procompetitive. With regard to policy, we continue to agree with the conclusion reached by Lafontaine & Slade (2007): “[B]y highlighting the importance of the different efficiency motives, the empirical evidence that we have reviewed suggests that vertical-merger policy should be de minimus [*sic*] if it exists at all.”³⁰

Evidence-based antitrust policy requires that this empirical evidence guide our thinking in whether there is a need to update the vertical merger guidelines and, more

²⁹ *United States v. AT&T Inc.*, No. CV 17-2511 (RJL), 2018 WL 3752091 (D.D.C. June 12, 2018).

³⁰ Lafontaine & Slade, *supra* note 3, at 662.

substantively, what a revised version would say.³¹ There are clear benefits to having updated guidelines to the degree that they offer greater transparency, predictability, and consistently. Yet the guidelines must be transparent, predictable, and consistent in the right way. Ultimately, we tend to agree with the recommendation offered by Werden (2009): “Issuing guidelines makes sense only if significant legal uncertainty exists and there is a real prospect that guidelines can materially mitigate that uncertainty, yet I have doubts on both points. I doubt that either the business community or merger practitioners are anxious about non-horizontal merger enforcement, and I doubt that useful guidance could be provided.”³²

³¹ See Joshua D. Wright, *Abandoning Antitrust’s Chicago Obsession: The Case for Evidence-Based Antitrust*, 78 ANTITRUST L.J. 241 (2012).

³² Werden, *supra* note 4, at 848.