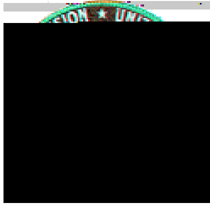

United States of America
Federal Trade Commission

Vertical Merger Policy: What Do We Know and Where Do We Go?

Christine S. Wilson[1]
Commissioner, U.S. Federal Trade Commission

Keynote address at the GCR Live
8th Annual Antitrust Law Leaders Forum

South Miami Beach, FL

February 1, 2019

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[1] The views expressed in these remarks are my own and do not necessarily reflect the views of the Federal Trade Commission or any other Commissioner. Many thanks to my Attorney Advisor, Keith Klovers, for assisting in the preparation of these remarks.

I. Introduction

Thanks to the team at Global Competition Review for inviting me to speak today. And thanks also to those of you who have traveled to be here. Some of you have come from abroad, while others – like me – have selflessly sacrificed a few blissful days in the Polar Vortex to be here in warm and sunny South Miami Beach.

Being in South Florida is a homecoming of sorts for me. I was born in Orlando, grew up in South Florida, and studied under Professor Roger Blair at the University of Florida during my undergraduate career. (Coincidentally, given the topic of my talk today, Professor Blair co-authored a book on vertical integration that still sits on my bookshelf.[1])

Before launching into the substance, I must provide the standard disclaimer: The views I express today are my own, and do not necessarily reflect the views of the Federal Trade Commission or any other Commissioner.

With the administrative details out of the way, I would like to spend our time together this morning on the topic of vertical merger policy. Specifically, over the next 30 minutes I will summarize the FTC's recent action and statements in the Staples / Essendant matter, build on the issues raised in the various Commission statements by reviewing what we know about the likely competitive effects of vertical mergers, and, given what we know, examine whether it makes sense for the Commission to set out its views on vertical merger analysis, either by issuing new Vertical Merger Guidelines or publishing those views in some other format.

II. The Staples / Essendant Decision

A. The Commission Order and Statements

You may have heard that, earlier this week, the Commission accepted a consent order to resolve potential competitive concerns associated with Staples' acquisition of Essendant.[2]

The transaction combined Staples, a leading retailer of office supplies, with Essendant, a leading wholesaler. Both firms serve medium-sized business customers. Staples does so directly, albeit with only limited success. Essendant does so indirectly by supplying smaller dealers who in turn supply these customers. As a technical matter, the merger was not vertical in nature, as Essendant is neither up04 Tc 0.004 -3 -1.jnca conse3 12 (,)]TJ 0 Tc 0 Tw 9.22 0 Td ( )Tj 2 Tc

Chopra and Rebecca Slaughter dissented.[3] Altogether, the Commissioners issued four statements – one by the majority and three separate statements by Commissioners Chopra, Slaughter, and me.[4] Although I commend all of the statements to you, allow me to summarize

Broadly speaking, the statements fell into two categories. First, the majority and our dissenting colleagues debated various points related to the case itself. For example, the statements addressed whether the firewall

First, we know that competitive harm is less likely to occur in a vertical merger than in a horizontal one. Vertical mergers by definition combine firms that operate at different levels of production. Consequently, a vertical merger does not alter concentration in any relevant market.[14] Purely vertical mergers therefore do not implicate many of the key competitive dynamics – and particularly the elimination of current competition between the merging firms – at play in horizontal mergers.[15] Indeed, Professor Steven Salop, another former mentor of mine who has written extensively on the potential harms from vertical mergers, agrees that competitive harm is likely to occur only in a narrow set of circumstances.[16]

Second, we know that integrating operations at different levels of production often yields clear economic benefits.[17] The most often cited of these is the elimination of double marginalization (EDM). Some commentators, including Professor Carl Shapiro, view EDM as a phenomenon "inherent" in vertical mergers.[18] The FTC's Director of the Bureau of Competition, Bruce Hoffman, has said likewise.[19]

Vertical mergers create other benefits, as well. They allow firms at successive levels of the supply chain to coordinate their production, design, or innovation activities, thereby reducing costs, increasing quality, and speeding the introduction of new products.[20] They also incentivize

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[14] For example, if a merger unites a firm with 30 percent of the upstream market and a firm with 25 percent of the downstream market, immediately after close the combined firm would still control 30 percent of the upstream market and 25 percent of the downstream market. Its shares would not have changed, and neither would those of its competitors. In contrast, a horizontal merger combining firms with 25 and 30 percent of the same relevant antitrust market would result in a combined firm with 55 percent market share and a marketplace with one fewer competitor.

[15] See, e.g., D. Bruce Hoffman, Director, FTC Bureau of Competition, Vertical Merger Enforcement at the FTC: Remarks at the Credit Suisse 2018 Washington Perspectives Conference, at 2-3, Washington D.C., Jan. 10, 2018, available at https://www.ftc.gov/system/files/documents/public_statements/1304213/hoffman_vertical_merger_speech_final.pdf ("In contrast [to horizontal mergers], vertical mergers do not combine substitutes, and in fact often involve complements . . . . Where horizontal mergers reduce competition on their face . . . vertical mergers do not.").

[16] See Michael H. Riordan & Steven C. Salop, Evaluating Vertical Mergers: Reply to Reiffen and Vita Comment, 63 ANTITRUST L.J. 943, 944 (1995) (agreeing with other commentators that "efficiency benefits provide the rationale for many vertical mergers, can lead to increased competition and consumer welfare, and are sufficient to offset potential competitive harms in many cases"); Steven C. Salop, Revising the Vertical Merger Guidelines: Presentation at the FTC Hearings on Competition and Consumer Protection in the 21st Century, at 8 (Nov. 1, 2018), available at https://www.ftc.gov/system/files/documents/public_events/1415284/ftc_hearings_5_georgetown_slides.pdf ("A stronger overarching procompetitive presumption for vertical mergers does not make sense in oligopoly markets.")

[17] For the seminal work, see R.H. Coase, The Nature of the Firm, 4 ECONOMETRICA 386 (1937).

[18] Transcript at 19, 25, 116, 141, FTC Hearings on Competition and Consumer Protection in the 21st Century, Hearing #5 (consumer welfare and vertical merger policy), available at https://www.ftc.gov/system/files/documents/public_events/1415284/ftc_hearings_session_5_transcript.pdf-11-1-18 (statements of Prof. Shapiro) ("[T]here are some inherent efficiencies – at least possible efficiencies including elimination of double marginalization. . . . So I think what is fundamentally different is that how do we handle the efficiencies in the vertical deals than horizontal, and we are hearing from panels about these inherent efficiencies, which economists would agree with, including me.")

[19] Remarks of D. Bruce Hoffman, supra note 15, at 3 ("Due to the elimination of double marginalization and the resulting downward pressure on prices, vertical mergers come with a more built-in likelihood of improving competition than horizontal mergers.").

[20] See, e.g., Salop, Revising the Vertical Merger Guidelines, supra note 16, at 13.

greater investment by harmonizing upstream and downstream incentives and by reducing transaction costs, “free-riding,” and the risk of hold-up.[21] Several current and former FTC economists explained in an academic paper that the efficiencies of vertical control, including especially EDM, “often rise[] monotonically with the level of pre-existing market power.”[22]

Third, we know that economic models that attempt to predict the net competitive effects of a given potential vertical merger are often more art than science. For example, Michael Salinger (a former head of the FTC’s Bureau of Economics) characterizes these models, and particularly those attempting to predict competitive harm, as “highly stylized” and “largely game-theoretic.”[23]

Fourth, retrospective empirical analyses confirm that vertical mergers are typically procompetitive. I cite a handful of academic studies in my Staples statement,[24] and the Global Antitrust Institute submission to the FTC does a nice job of collecting a variety of these retrospectives.[25] Not surprisingly, retrospectives of vertical mergers conclude that most vertical mergers turn out to be procompetitive.

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In summary, we know: (i) vertical mergers raise different competitive dynamics than horizontal ones; (ii) vertical mergers often yield substantial efferrrrrtical me1TJ - (i)-5;(i)-2 (004.22 ii1 (-

to all other possible approaches? Third, if we do decide to issue guidelines, what topics should they cover?

A. Are New Vertical Merger Guidelines Consistent with the Reasons We Issue Antitrust Guidelines?

Several folks have thought deeply about why the agencies issue guidelines. Therefore I must note at the outset that I am indebted to the excellent work that Greg Werden, Paul Yde, the Global Antitrust Institute at George Mason, and others previously have done on the topic.[27]

Drawing upon their work, I submit there are at least four reasons why the antitrust agencies issue guidelines.

First, the agencies may use guidelines as a way to summarize the law, just as the American Law Institute issues Restatements of the law of contracts, property, and other topics.

Second, the agencies may use guidelines to clarify how they intend to approach topics on which there is no clear binding precedent. For example, Werden explains that the 1968

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codifying existing agency practice – help the public understand how the agencies are likely to evaluate a given proposed transaction. We therefore ensure that parties contemplating an anticompetitive transaction know we are likely to challenge it. On the other side of the coin, we also ensure we do not chill procompetitive transactions that we are unlikely to challenge. Guidelines similarly inform Congress, the press, and other constituencies.

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Alternatively, the agencies could provide "soft" guidance through other official agency documents. For example, in 2006 the FTC and DOJ jointly issued the Commentary on the Horizontal Merger Guidelines.[35]

Finally, the agencies could provide "soft" guidance through individual statements by the senior leadership of both agencies. This speech is one example – although it of course reflects my personal view, not the official agency view. This limitation means individual statements provide even less definitive guidance on what

years of practice. Of course, in Staples the Commission found only one competitive harm and fully rectified it by imposing a firewall. Therefore, as the majority statement says, we had no need to consider whether there were offsetting efficiencies in that case.[38]

In any event, in contrast to horizontal guidelines, the economics in vertical mergers indicate efficiencies are much more likely. Professor Shapiro went so far as to call them "inherently" likely at our hearing.[39] Given this dynamic, it may be appropriate to presume that certain vertical efficiencies are verifiable and substantial in the absence of strong evidence to the contrary, even if we would not do so in a horizontal merger case.

What we say also depends upon which welfare standard we apply, which was another topic of conversation at the November 2018 hearing.[40] For example, if we were to adopt a total welfare standard, we would no longer need to evaluate whether and to what extent cost savings would be passed through to consumers.

We should similarly address how we would assess merger specificity. As I explained a moment ago, in horizontal mergers we credit only efficiencies that the parties can demonstrate are merger-specific. The Horizontal Merger Guidelines also state that "the Agencies do not insist upon a less restrictive alternative that is merely theoretical."[41] Given the different economic dynamics in vertical mergers, a different merger-specificity rule may be warranted.

Indeed, considering the many ways firms can structure a vertical relationship, a standard that includes everything but "merely theoretical" less restrictive alternatives does not provide a meaningful limiting principle when applied to vertical mergers. Moreover, many economists, including Paul Joskow, Ben Klein, and Oliver Williamson, recognize that vertical contracting may be possible but less efficient than vertical integration by merger for several reasons.[42] Merging also eliminates various transaction costs inherent to contracting models. Under these circumstances, I believe it would be appropriate to set a high bar for less restrictive alternatives

[38] See Majority Statement, supra note 4, at 1 ("[T]he Commission has voted 3-2 to issue a complaint and accept a settlement, which would resolve the only competitive concern arising out of this transaction that is supported by the evidence. . . . To resolve this issue, the Commission's proposed order imposes firewalls and other safeguards to protect the competitively sensitive information of Essendant's dealer customers, as well as the sensitive information of the customers of those dealers.").

[39] See supra note 18 & accompanying text.

[40] See FTC Hearings on Competition and Consumer Protection in the 21st Century, Hearing #5 (consumer welfare and vertical merger policy), available at https://www.ftc.gov/news-events/events-calendar/ftc-hearing-5-competition-consumer-protection-21st-century

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in vertical merger cases, ruling out far more than the “merely theoretical” options we exclude in horizontal cases.

4. Remedies

continue to conduct merger retrospectives, including vertical merger retrospectives, to further advance our learning and refine our enforcement policies.