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How Will the FTC Evaluate Vertical Mergers?

BY CARL SHAPIRO, HERBERT HOVENKAMP September 23, 2021

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The building of the Federal Trade Commission in downtown Washington, DC. Photo by RiverNorthPhotography, via Getty Images

The Federal Trade Commission's recent withdrawal of its 2020 vertical merger guidelines is flatly incorrect as a matter of microeconomic theory and is contrary to an extensive economic literature about vertical integration.

On September 15th, 2021, by a 3-2 vote, the Federal Trade Commission withdrew the Vertical Merger Guidelines that had been jointly issued by the FTC and the Department of Justice in 2020.

In some respects, the FTC's action makes perfect sense: two Democratic Commissioners had dissented when the VMGs were issued, FTC Chair Lina Khan's writings made clear her antipathy to vertical integration before she was nominated, and good government requires that agency guidelines accurately reflect current enforcement policy.

But there are some very worrisome aspects of what the FTC just did.

First, the Department of Justice did *not* withdraw the 2020 VMGs. It issued a statement saying that the 2020 VMGs "remain in place" at the Department of Justice. This leaves the Biden Administration law enforcement policy regarding vertical mergers in disarray, creating wholly unnecessary uncertainty for the business community. Is that really what the White House wants?

Second, contrary to its transparency rhetoric, the FTC acted without the benefit of any public comment. As the DOJ pointed out in its statement: "Public comment, which has not yet been sought on the substantial changes made to the published version of the Vertical Merger Guidelines, will be helpful in considering a range of questions."

Third, in its attempt to explain why it withdrew the 2020 VMGs, the FTC majority statement relied on specious economic arguments. The majority critiqued "the 2020 VMGs' flawed discussion of the purported procompetitive benefits (i.e., efficiencies) of vertical mergers, especially its treatment of the elimination of double marginalization ("EDM")." This "could become difficult to correct if relied on by courts."

The theory of EDM is that a vertical merger can promote competition by eliminating double markups that occur when two independent firms sell and then resell something. In some cases, EDM justifies a vertical merger, but in other cases it does not. In its withdrawal statement, however, the FTC majority wrote this:

> ***"The VMGs' reliance on EDM … is theoretically flawed because the economic model predicting EDM is limited to very specific factual scenarios: mergers that involve one single-product monopoly buying another single-product monopoly in the same supply chain, where both charge monopoly prices pre-merger and the product from one firm is used as an input by the other in a fixed-proportion production process. Yet outside this limited context, economic theory does not predict that EDM will create downward pricing pressure."***

This statement is flatly incorrect as a matter of microeconomic theory. EDM applies (a) to multi-product firms, (b) regardless of whether the firms at either level have monopoly power or charge monopoly prices, and (c) regardless of whether the downstream production process involves fixed proportions. All of this has been included in economics textbooks for decades, building on a seminal 1950 paper by Joseph Spengler. None of the conditions cited by the majority are required for EDM to apply, although they are clearly relevant when one is *measuring* EDM in a specific vertical merger. While EDM does not save every vertical merger, it should be part of any vertical merger inquiry and is not nearly as limited as the majority's statement suggests.

In drafting its statement, the majority appears not to have consulted with the FTC's own Bureau of Economics. As a result, we have the spectacle of a federal agency basing its policies on a demonstrably false claim that ignores relevant expertise. Perhaps we are naïve, but we had been hoping that would stop when Donald Trump left office.

> **"WHEN THE FTC INVESTIGATES VERTICAL AND HORIZONTAL MERGERS WILL IT NOW TAKE THE POSITION THAT EFFICIENCIES ARE IRRELEVANT, EVEN IF THEY ARE PROVEN? IS SO, THE FTC WILL FACE EMBARRASSING LOSSES IN COURT."**

When the FTC investigates vertical mergers, will it dismiss EDM in cases that do not fit the very narrow fact pattern which the majority (incorrectly) believes to be the only one in which EDM applies? That could lead to enforcement errors and the prospect of embarrassing losses in court.

In addition, the FTC Press Release argues that the 2020 Vertical Merger Guidelines' approach to efficiencies was inconsistent with the language of the Clayton Act because efficiencies "are not recognized by the statute as a defense to an unlawful merger."

Khan elaborates in her separate statement:

> ***"In particular, the 2020 VMGs contravene statutory text, improperly suggesting that efficiencies or "procompetitive effects" may rescue an otherwise unlawful transaction."***

This is baffling. The statutory text prohibits mergers whose effect "may be substantially to lessen competition, or to tend to create a monopoly." Consider a merger between two of the smaller firms in a concentrated market. In the absence of any efficiencies, such a merger could well be illegal, by eliminating the direct competition between those two firms (unilateral effects) or by making it easier for the remaining firms to collude (coordinated effects). Suppose, however, that the merger would enable these two smaller firms to achieve economies of scale, with the result that output is higher and prices lower then without the merger. There is no logical sense in which that merger would "lessen competition," so the merger cannot violate the statute. The legality of the merger thus must hinge on those efficiencies, yet the new FTC would ignore them.

Inexplicably, the Chair also categorically dismisses "procompetitive effects" in merger analysis. How can that make any sense? If a merger will generate procompetitive effects and thus will *promote* competition, on what basis can the Chair claim that the merger will substantially *lessen* competition, a requirement that is explicit in the text of the statute? Indeed, if mergers never produced procompetitive effects they could be condemned under a per se rule, but neither the statutory language nor a century of enforcement history permits that.

The FTC's statement is contrary to a broad consensus among economists going back at least to a seminal 1968 article by Oliver Williamson. In many cases a merger (horizontal or vertical) will do no competitive harm because its efficiencies will completely offset any threatened anticompetitive effects. But this is a factual query. Further, the FTC's statement is flatly inconsistent with the Horizontal Merger Guidelines issued by the DOJ and the FTC. Ironically, the aggressive antitrust enforcer and FTC Chair Robert Pitofsky recognized the need to include efficiencies in the merger guidelines and in fact did so in 1997.

What does all of this mean for merger enforcement at the FTC? When the FTC investigates vertical and horizontal mergers will it now take the position that efficiencies are irrelevant, even if they are proven? Is so, the FTC will face embarrassing losses in court.

Our view is that Vertical Merger Guidelines should make clear that the merging parties bear the burden of establishing EDM, just as they bear the burden of establishing all efficiencies in horizontal as well as vertical mergers. In a recent paper, one of us has described how to determine whether the efficiencies associated with EDM are cognizable, and if so how to measure them,

Finally, merger review is not just about price effects. Often the effect of a merger on product quality and innovation is far more important. In vertical mergers, EDM receives a lot of attention because it is well understood and amenable to quantification. But we find it very helpful to think of EDM as just one example of a far more general concept: *some supply chains are handled more efficiently within a single firm than through contract.* An extensive economic literature about vertical integration and "make or buy" decisions teaches us that vertical integration can spur innovation and greatly benefit consumers, especially when new methods require risky investments and coordination throughout the supply chain. Oliver Williamson won a Nobel Prize in 2009 for his work on these issues. There are many powerful historical examples where vertical integration promoted innovation by firms producing technologically complex products, including sewing machines, farm equipment, and cameras, as documented by the great economic historian, Alfred Chandler in his 1977 masterpiece, *The Visible Hand: The Managerial Revolution in American Business*. If the FTC does not understand that basic point about how our economy operates, they are likely to cause real harm.

Disclosure: Carl Shapiro testified in 2018 on behalf of the Department of Justice in its challenge to the AT&T/Time Warner merger, and in 2019 on behalf of a group of State Attorneys General challenging the T-Mobile/Sprint merger. Shapiro also testified on behalf of Steves Doors in its private challenge to a horizontal merger. In recent years, Shapiro testified on behalf of the FTC in its challenge to the Staples/Office Depot merger and in its non-merger cases against Qualcomm, AbbVie, and Actavis. Shapiro also was retained by the FTC as an economic expert in the past three years on two other matters that he is not authorized to disclose. Shapiro has also provided antitrust advice to Google and Intel during the past three years.

Editor's note: the author's disclosure has been updated after publication.

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Carl Shapiro is Professor of the Graduate School at the Haas School of Business and the Department of Economics at the University of California at Berkeley. Shapiro had the honor of serving as a Senate-confirmed Member of the President's Council of Economic Advisers during 2011-12. For the two years immediately prior to that, he was the Deputy Assistant Attorney General for Economics at the Antitrust Division of the U.S. Department of Justice; he also held that position during 1995-96. Shapiro is the co-author, with Hal R. Varian, of Information Rules: A Strategic Guide to the Network Economy. Shapiro has published extensively in the areas of industrial organization, competition policy, patents, the economics of innovation, and competitive strategy. Shapiro also has testified as an expert witness on behalf of the government in a number of important antitrust cases.

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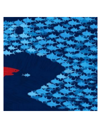

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