

Public Policy Toward Vertical Practices

Daniel P. O'Brien*

Senior Economic Policy Advisor
U.S. Federal Trade Commission

Bates White 10th Annual Antitrust Conference
June, 2013

*The views expressed herein are my own and do not purport to represent the views of the FTC or any FTC Commissioner.

Outline

- Two Parables
- Empirical Evidence Supporting the Parables
- Finding Outliers
 - The Role of Market Power
 - The Role of Economic Theory and Modeling
 - The Role of Effects Evidence
 - Balancing

Economics 201, Parable 1

Firms A and B have market power and compete with each other.

Q1. If firm A takes an action to increase its output, does firm B win or lose?

A1. It generally **loses**.

Q2. If A and B conspire, does output rise or fall?

A2. Output typically **falls**. The combination internalizes the negative externality from output expansion and expands output by **less**.

Lesson: Contracts/combinations between **horizontal competitors** with market power tends to **lower output** and harm consumers. (Exceptions occur when contracts/combinations have complementary effects.)

Economics 201, Parable 2

Firms A and B have market power and sell complementary products.

Q1. If firm A takes an action to increase its output, does firm B win or lose?

A1. It generally **wins**.

Q2. If A and B conspire, does output rise or fall?

A2. Output typically **rises**. The combination internalizes the positive externality from output expansion and expands output by **more**.

Lesson: Contracts/combinations between **complementary producers** with market power tend to **raise output** and benefit consumers. (Exceptions occur when contracts/combinations have horizontal effects.)

Conclusions from Parables 1 & 2

- Direct incentive effects of contracts or combinations between **horizontal competitors** with market power tend to reduce output.
- Direct incentive effects of contracts or combinations between **complementary producers** with market power tend to enhance output.
- In both cases, the direct incentive effects highlighted are intrinsic to the combinations.

Policy Implication(??) In concentrated markets, combinations of substitutes should be presumed bad and combinations of complements should be presumed good absent evidence to the contrary.

A Caveat, But...

- A potential countervailing effect:
 - If complementary producers A and B deal with each others' rivals, then a new contract/combination between A and B may alter their incentives in dealing with rivals, and this may have anticompetitive effects.
- However:
 - The direction of each of the intrinsic incentive effects described on the previous slides is unambiguous.
 - The countervailing effects that arise through dealings with rivals are ambiguous.
- Harm from a vertical contract/combination requires that the countervailing effect from changed incentives in dealing with rivals:
 - 1) Has the right sign, and
 - 2) Is big enough to offset the intrinsic effect.

Empirical Evidence Supports Lessons from the Parables

- Cooper, Froeb, O'Brien & Vita, IJIO (2005)
 - Reviewed 22 studies from the JEL database on the empirical effects of vertical practices.
 - Only 1 study found unambiguous anticompetitive effects (Ford & Jackson, 1997 on integration of cable into programming).
 - Effect was small, and lacks a theoretical explanation.
 - Differs from the findings of Chipty (2002).
 - Many studies found benefits from vertical practices.
- Lafontaine & Slade, Antitrust Handbook (2008)
 - Reviewed 23 papers on vertical practices.
 - Found that voluntary restraints tend to raise quality and service.
 - Found that government-imposed restraints tend to harm consumers.

Empirical Evidence cont...

- More Recent Papers

- Nonlinear pricing used to mitigate double mark-ups (Villas-Boas, 2007).
- Revenue sharing in video rental market used to mitigate double mark-ups (Mortimer, 2008)
- Bundling cold and pain medications lowered price (Evans & Salinger, 2008)
- ET used to induce dealer services (Zanarone, 2009)
- MD statute prohibiting RPM had no effect on video game prices (Bailey & Leonard, 2010)
- Full-line forcing used to mitigate double mark-ups (Ho, Ho, Mortimer, 2012)

Anticompetitive Vertical Practices: Finding the Outliers

- The Role of Market Power as a Screen
 - Market power is not a good test
 - Efficiencies from vertical restraints are often greatest when market power is highest
 - Market power is necessary but not sufficient for harm from vertical practices
- The Role of Economic Theory and Modeling
 - Many “possibility theorems”
 - Results are highly sensitive to details that are difficult to verify

Finding Outliers cont...

- The Role of Effects Evidence
 - This is the key!
 - Need evidence suggesting the likelihood of a net anticompetitive effect.
- Types of Evidence
 - Experiments in the data on likely output effects
 - Implications of documents for likely output effects