ROBERT L. STEINER

Comments HMG Review Project No. PO92900 11/11/2009

Summary – The Guidelines' failure properly to incorporate vertical relationships into its analysis can lead to rejecting mergers that are welfare enhancing and approving those that are not. Changes in costs, margins, prices, efficiencies, etc. at the level at which the merger is taking place cause changes in these parameters in vertically adjacent upstream and downstream markets which in turn alter the competitive environment facing the merged firm.

For example, in a merger of consumer goods manufacturers, the Guidelines specify that the parameters should be valued at the manufacturing stage with the unstated but erroneous assumption that the same parameter changes will be faithfully reflected at the retail stage. I have labeled this the "single-stage" paradigm in which the downstream markets are "analytically neutral" (R.B. Hefflebower.) Yet due to the pervasive tendency for margins in manufacturing and retailing to be inversely related, should the merger strengthen the consumer franchise of its brands, the retail prices of the merged firm's brands may actually fall despite increases in their factory prices.

In antitrust law competition is an exclusively horizontal process. But In the real world relationships between firms at adjacent levels have both a complementary and a competitive dimension. The challenge for the Agencies is to quantify vertical market power and combine it with conventional measures of horizontal market power to predict the total market power of the merged firm in the relevant markets.

2 important examples of single-stage assumptions – Many of its analytic tools, including the computation of the SSNIP and Critical Loss, fail to track how changes in costs, margins, etc. at vertically adjacent stages due to the proposed merger alter competitive conditions facing the merged firm.

Total surplus, an excellent measure of welfare, is defined as the sum of producer and consumer surplus. Note the omission of distributor surplus (wholesaler + retailer), justified only if the distribution stages are perfectly competitive and therefore analytically neutral.

Horizontal and Vertical Competition In vertical upstream competition, consumer goods manufacturers strive to lower their invoice costs by beating down the margins of their suppliers. In vertical downstream competition they strive to raise their share of their brands' retail price by driving down their retailers' margins and thereby obtain a lower retail price at any factory price. A more successful vertical competitor can buy cheaper and sell dearer than its horizontal rivals and hence has more market power than rival producers with the same or somewhat higher horizontal market shares. Horizontal and vertical competition are positively related. A larger horizontal market share also normally enables the firm to buy for less and sell for more. The Agencies must inquire whether the merged firm will become a more successful vertical competitor, for it is difficult for incumbent firms and prospective entrants to compete against a merged firm that can buy cheaper and sell dearer than they can.

<u>Market power in consumer goods industries.The inverse association between margins at the 2 stages.</u> – With weak brands consumers will switch brands within store rather than stores within brand should a retailer fail to stock a brand or to price it competitively. The absence of vigorous interbrand or intrabrand competition among stores raises retailers' margins, but their high elasticities of substitution enable them to play off one maker against the others, producing thin manufacturers' margins.

With famous brands the consumer brand and store switching behavior is reversed as are the size of relative margins at the 2 stages. Yet they remain negatively associated. Retailers have thin margins on the best known brands because they understand that consumers easily recognize them as homogeneous across stores and fear to be caught with a higher price than other stores on what consumers will identify as the same thing. The famous brand manufacturer knows that retailers must stock his brand, so he can profitably markup his factory price above the competitive level without losing much distribution or dealer support.

The Agencies must recognize that retail prices can rise by less and output increase by more than predicted in a single-stage analysis at the manufacturer level. It is also possible (but less likely) should the merger be predicted to lead to retail price maintenance that prices at the retail level would rise by more than at the manufacturer stage.

<u>Guideline Definitions of seller and buyer market power</u> - The ability to hold prices above the competitive level for a substantial period of time is a good definition of seller power, but again does not indicate the total of monopoly profits in the vertical system. The definition of buyer power as the ability to force sellers to price below the competitive level by reducing output is badly flawed. The seller cannot do that unless it has diseconomies of scale, contrary to empirical findings of initially increasing and then generally constant returns to scale for manufacturing firms. It also follows from this unfortunate definition that a Wal-Mart that forces down the seller's price but not below the competitive level, and likely increases output as well, has no market power.

<u>References</u> – See the following articles by Robert L. Steiner: *The Inverse Association between the Margins of Manufacturers and Retailers*, Review of Industrial Organization, vol.8 #6 (1993). *Vertical Competition, Horizontal Competition and Market Power*, Antitrust Bulletin vol. 53 #2 (summer 2008) and the references included therein including *The Nature of Vertical Restraints,* Antitrust Bulletin, vol. 30 #1 (1985.

Also see article by Michael P. Lynch, former Director of FTC's Bureau of Economics, *Why Economists are Wrong to Neglect Retailing and how Steiner's Theory Provides an Explanation of Important Regularities*, Antitrust Bulletin, vol. 49 (winter 2004).