Federal Trade Commission

THREE VERTICAL ISSUES: A PERSPECTIVE

Remarks of

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The views expressed are those of the Commissioner and do not necessarily reflect those of the Federal Trade Commission or any other commissioner.

Good afternoon. It is a pleasure to join you today at this seminar on distribution, marketing and franchising. I have been designated as the "keynote" speaker. Given that and the fact that I am speaking immediately after lunch, perhaps it is appropriate to take a somewhat ruminative approach, to relax and reconsider two issues that have been chewed over in the past as well as to bite off one new one.

These are heady times for antitrust enforcement. The Federal Trade Commission is continuing the high level of enforcement that it has maintained for some time. After the departure of two of our colleagues, Commissioners Owen and Yao, at the end of the summer, we are happy to welcome our new Commissioner, Christine Varney, and eagerly await the confirmation and arrival of the President's nominee to fill the second vacancy, Robert Pitofsky. The President has also named Mr. Pitofsky to chair the agency. At our sister agency, the Department of Justice, it is no longer news that Anne Bingaman, the Assistant Attorney General in charge of the Antitrust Division, brings an infectious dynamism to the task of enforcement.

This is a time of transition, and transition involves reexamination, renewal and change. Standing at the cusp of a new regime at the FTC, I want to discuss today three areas that seem timely: first, resale price maintenance; second, vertical mergers; and third, a recent case of the Commission that is novel

and that demonstrates our continuing efforts to deal with new situations and new issues. At this point, I will add my customary disclaimer that I express my own views and not necessarily those of the Commission or any other commissioner.

I.

Although this morning's program included a presentation on resale price maintenance, I want to return to the issue and add some perspective and a few observations of my own. The Federal Trade Commission's vertical restraints enforcement program was perhaps most visible in the 1970's, after the demise of state fair trade laws, which protected resale price maintenance from federal law, and before GTE Sylvania,[1] in which the Supreme Court held that non-price vertical restraints should be analyzed under the rule of reason.

Some have called the shift in emphasis from vertical restraints enforcement the "Reagan Revolution," but as Richard Steuer has pointed out, a "shift in [antitrust] philosophy first appeared in the mid-1970's," not at the federal enforcement agencies, but "in some pivotal decisions of the United States Supreme Court and the lower federal courts."[2] In the vertical restraints area, GTE Sylvania in 1977 was one of those pivotal decisions. Seven years later, in Monsanto,[3] the Court reaffirmed

[1] Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977).

[2] R. Steuer, "The Turning Points in Distribution Law," 35 Antitrust Bull. 467, 467-68 (1990).

[3] Monsanto Co. v. Spray-Rite Service Corp., 465 U.S. 752 (1984).

the protections afforded by Colgate and Sylvania and made more clear the sphere of lawful distribution practices by limiting the circumstances in which a vertical agreement on price may be inferred.

The issue in Monsanto, whether an unlawful agreement could be inferred from termination of a discounter following price-related complaints from other dealers, brought before the Court the tensions between the different treatment under the law of nonprice vertical restraints and resale price maintenance. Although the Court in Sylvania said that conduct should be "judged primarily by its 'market impact,'"[4] in Monsanto, the Court recognized that the economic effect of both price and nonprice vertical restraints "is in many . . . cases similar or identical" and the conduct may be "indistinguishable."[5] When this occurs, the Sylvania "market impact" test would not distinguish between price and nonprice restrictions, and the question would arise whether the per se rule for resale price maintenance should be retained.[6]

At the same time, allowing relatively easy inferences of unlawful agreements from price-related discussions between a seller and its dealers could limit communications identified in

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[4] 465 U.S. at 762.

[5] Id. at 762.

[6] See Concurring Opinion of Justice White in Sylvania, 433 U.S. 59, 69-70 ("It is common ground among the leading advocates of a purely economic approach . . . that the economic arguments in favor of allowing vertical nonprice restraints generally apply to vertical price restraints as well." (Citations omitted.)).

Sylvania as legitimate or even procompetitive.[7] In Monsanto, the Court apparently sought to protect both "the market-freeing effect of [its] decision in GTE Sylvania"[8] and the per se rule against resale price maintenance by requiring that an unlawful agreement be proved by evidence "that tends to exclude the possibility that the manufacturer and nonterminated distributors were acting independently."[9]

After Sylvania and before Monsanto, the academic debate about vertical restraints focused on the different legal treatment accorded price and nonprice restraints. Many argued that resale price maintenance and nonprice vertical restraints often were similarly motivated and had similar consequences and, therefore, should be similarly analyzed under the rule of reason.[10] Both before and after Monsanto, discussion at the Commission focused on the elements necessary to prove an unlawful agreement. After Monsanto and then Sharp, arguably it was more difficult to prove an unlawful agreement, and the number of new resale price maintenance cases at the Commission diminished.

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[7] 465 U.S. at 762 ("[I]t is precisely in cases in which the manufacturer attempts to further a particular marketing strategy by means of agreements on often costly nonprice restrictions that it will have the most interest in the distributors' prices.").

[8] Business Electronics Corp. v. Sharp Electronics Corp., 485 U.S. at 726.

[9] Monsanto, 465 U.S. at 764.

[10] See, e.g., T.R. Overstreet, Jr., Resale Price Maintenance: Economic Theories and Empirical Evidence, Bureau of Economics Staff Report to the Federal Trade Commission 10 (Nov. 1983).

This does not mean, of course, that enforcement against resale price maintenance has disappeared. Earlier this year, the Commission issued a consent order with The Keds Corporation, settling resale price maintenance charges.[11] In 1991, the Commission accepted consent agreements barring resale price maintenance in Nintendo of America, Inc.,[12] and Kreepy Krauly, U.S.A., Inc.[13] Keds, Nintendo and Kreepy Krauly are traditional resale price maintenance cases, based on unambiguous evidence of agreement. The prosecutorial decision whether to bring a case may entail consideration of matters other than the evidentiary judgment of whether a violation occurred. If a seller's attempts to maintain prices are only episodic, ineffective or limited in other important ways, for example, there may be better uses for our scarce enforcement resources.

After a decade and more of adjusting to Sylvania and Monsanto, the decision of the Supreme Court in Kodak[14] again generated a great deal of debate. Kodak was hailed by some as a repudiation of the primacy of economic theory in antitrust analysis following Sylvania in favor of a return to reality.[15]

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[11] The Keds Corporation, Docket C-3490 (April 5, 1994).

[12] Docket C-3350 (Nov. 14, 1991).

[13] Docket C-3354 (Dec. 20, 1991).

[14] Eastman Kodak Co. v. Image Technical Services, Inc., 112 S. Ct. 2072 (1992).

[15] E.g., W.B. Markovits, "A Focus on Reality in Antitrust: An Analysis of the Kodak Case," 39 Fed. B.J. 592 (Nov./Dec. 1992); S. Salop, "Kodak as Post-Chicago Law and Economics," Charles River Associates (April 1993).

According to one commentator, the opinion of the Court made clear "that defendants must do more than simply shout 'free rider' in a crowded courtroom in order to prevail on the merits."[16] In Kodak, the Court said that it "preferred to resolve antitrust claims on a case-by-case basis, focusing on the 'particular facts disclosed by the record,'"[17] not theoretical arguments.

To hypothesize a change in approach at the Commission after Kodak, one would have to assume that we have been relying more on theory than on fact. I think that has not been the case. Because almost anything can be true in theory, in making enforcement decisions, theory is only useful in combination with facts. In vertical restraints cases, economic analysis applied to the facts can help provide alternative explanations for conduct and predict competitive effects. To the extent that Kodak may suggest a richer analysis, I think that the Federal Trade Commission has been ahead of its time.

II.

The second subject that I would like to raise with you involves vertical merger enforcement under Section 7 of the Clayton Act. The 1984 Merger Guidelines of the Department of

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[16] Salop, supra note 43, at 1. Former Antitrust Division Deputy Assistant Attorney General for Economics Janus Ordover responded that "simply shouting 'installed base opportunism' in a crowded court does not . . . justify a denial of a summary judgment." Antitrust 45 (Spring 1993).

[17] 112 S. Ct. at 2082 (citations omitted).

Justice still provide the best source of guidance on how the antitrust agencies analyze vertical mergers. The 1992 Horizontal Merger Guidelines, jointly issued by the Department of Justice and the Federal Trade Commission, refer back to the 1984 Merger Guidelines as the source for guidance on the analysis of vertical mergers.

The 1984 Guidelines anticipate competitive harm from vertical mergers manifested on a horizontal level in a well defined antitrust market, whether it is the upstream or downstream market. The Guidelines describe several distinct theories of competitive harm that may result from a vertical merger. The first theory in the Guidelines is that vertical integration of firms in two markets may increase the barriers to entry in a relevant market by requiring entry at several levels. The competitive harm is manifested in the market in which barriers are heightened, and the Guidelines describe circumstances under which such harm is likely. Another theory is that vertical integration by upstream firms into retail sales may facilitate collusion at the upstream level by making price monitoring easier. Under this theory, the Guidelines indicate that a challenge is not likely unless the upstream market is highly concentrated and a large percentage of the upstream product is sold through vertically integrated retail outlets. The Guidelines also suggest that an acquisition of a disruptive buyer may facilitate collusion in an upstream market and that a challenge, based on this theory, is unlikely unless the upstream

market is concentrated and the disruptive firm differs "substantially," in terms of the volume of purchases or other relevant characteristics, from other firms. Another theory relates to the evasion of rate regulation by monopolies subject to regulation.

The current Guidelines approach to vertical mergers was not always followed. In Brown Shoe Co. v. United States, 370 U.S. 294, 323-24 (1962), the Supreme Court observed that the harm from vertical integration is to foreclose the competitors of either merging party from the opportunity to compete. A number of cases, brought by the Commission and the Antitrust Division, focused on the prediction that markets would be foreclosed to a competitor as a result of a vertical merger, but did not entail detailed proof of anticompetitive harm resulting from the foreclosure.[18]

The Court of Appeals decision in Freuhauf Corp. V. FTC, 603 F.2d 345 (2d Cir. 1979), dealt a blow to the approach to liability that focused on the fact of foreclosure without detailed proof of competitive harm. Freuhauf, a maker of truck trailers, acquired Kelsey-Hayes, a maker of heavy duty wheels and antiskid braking devices that were used in making trailers. The Commission observed that the merger between a major customer and a supplier may restrain competition in the supplier's products (wheels and brakes) by foreclosing competitors of the supplier

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[18] See, e.g., Ford Motor Co. v. United States, 405 U.S. 562 (1972); Ash Grove Cement Co. v. FTC, 577 F.2d 1368 (9th Cir.), cert. denied, 439 U.S. 982 (1978);

with the following anticompetitive effects: (1) increasing market concentration in the supplier's market for wheels and brakes, (2) making market participation more difficult for smaller suppliers, and (3) rendering entry at the supplier level more difficult because of the diminished opportunity to sell to the foreclosed customer. Freuhauf Corp., 91 F.T.C. 132, 221-22 (1978).

The Second Circuit criticized the Commission's approach and declined to enforce the divestiture order. The Court of Appeals decided that the competitive harm resulting from foreclosure must be demonstrated, not assumed. Absent very high market concentration or other source of a "tangible anticompetitive effect," the court was unwilling to accept vertical foreclosure alone as a basis for liability. 603 F.2d 352 and 352 n.9. It said that "[a] showing of some probable anticompetitive impact is still essential . . . ," although there are no "precise formulas for determining whether a vertical merger may probably lessen competition." 603 F.2d at 353.

At about the time of the Second Circuit's Freuhauf decision, a number of scholars also criticized the foreclosure approach. See, e.g., 4 P. Areeda & D. Turner, Antitrust Law ¶ 1004 at 211 (1980); R. Bork, The Antitrust Paradox 226, 237 (1978); Page, Antitrust Damages and Economic Efficiency, 47 U. Chi. L. Rev. 467, 495 (1980). In Alberta Gas, the Court of Appeals for the Third Circuit endorsed the views of these commentators and rejected a finding of harm based purely on foreclosure. In

Alberta Gas Chemicals v. E.I. du Pont de Nemours and Co., 826 F.2d 1235 (3d Cir. 1987), cert. denied, 486 U.S. 1059 (1988), Alberta Gas, a methanol producer, sued du Pont, which also produced methanol, alleging that its acquisition of Conoco violated Section 7. Conoco was a consumer of methanol, and one of Alberta's theories was based on vertical foreclosure, resulting from Conoco's purchases of methanol from du Pont after the merger. The Court of Appeals observed that a vertically integrated firm will engage in self-dealing when it is profitable to do so. 826 F.2d at 1244-45. The court also observed that if the merger allowed the purchaser to obtain supplies at a lower cost, then "post-merger self dealing could result in efficiencies reflected in lower prices to the ultimate consumer." 826 F.2d at 1245. It held that injury to a competitor from such self-dealing did not constitute antitrust injury for purposes of standing, observing that the "competitor's losses would spring from the efficient aspects of the merger." 826 F.2d 1245.

The Alberta Gas case was a private, damages action by a competitor of one of the merging firms, and may be distinguished from a Commission action based on the public interest. Nonetheless, it should serve as a caution about the appropriate weight to give to complaints by competitors and theories of harm based solely on possible harm to competitors of the merging firm.

I do not intend a comprehensive review and balancing of the case law, but it is important to note that the economic theories articulated in Alberta Gas have not been universally embraced.

In United States v. American Cyanamid Co., the district court, in granting an application to terminate a consent order, observed that "[c]ontemporary economic theory recognizes that vertical integration may foster corporate efficiency and enhance competition in the market place." United States v. American Cyanamid Co., 556 F. Supp. 361, 369 (S.D.N.Y. 1983). The United States had consented to the termination, but a competitor opposed it. The Court of Appeals reversed and said that it was an error to apply "contemporary economic theory." United States v. American Cyanamid Co., 719 F.2d 558, 567 (2d Cir. 1983), cert. denied, 465 U.S. 1101 (1984). It remanded for the district court to make findings on the factors considered in vertical merger analysis as set forth in Brown Shoe, Freuhauf, and other precedent and to determine whether the conditions that the decree was intended to remedy still existed. Id.

In two recent vertical cases, the Commission accepted consent orders. In Tele-Communications, Inc.,[19] the order required TCI and an affiliate to divest their interest in QVC. In Martin Marietta Corp.,[20] the order imposed a restriction on access to confidential competitive information.

The Commission has examined several acquisitions in which manufacturers have decided to integrate forward into distribution. In the health care area, for example,

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[19] File No. 941-0008 (Nov. 15, 1993). The Commission withdrew the order after the parties abandoned the transaction.

[20] File No. 941-0038 (June 22, 1994).

pharmaceutical manufacturers have acquired prescription benefit management (PBM) firms. For example, when Merck acquired Medco, the Commission conducted an investigation and ultimately closed the investigation without challenging the merger.[21] That acquisition and others have been widely reported and discussed in the business press. Of course, I do not and cannot confirm any accounts in the press. I emphasize that my comments about vertical merger analysis in this context are not intended to reflect a view about any particular transaction, but simply to raise some common analytical problems.

Prescription benefit management firms (PBM's) are a relatively recent innovation. These firms provide services related to the management of a pharmacy benefit program. Their customers are the providers of managed care plans that offer pharmacy benefits, such as insurers, employers, and other third party payors. Although the Commission has not challenged such a vertical acquisition, we have received complaints from public interest groups and others, expressing serious concerns about vertical integration by the drug manufacturers.

One concern about the vertical integration relates to PBMs' role in cost containment for pharmacy benefit plans. Most PBMs provide a formulary, which is a list of drugs covered by the pharmacy plan. A PBM negotiates on behalf of its customers with

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[21] Letter from Barbara A. Clark, Director of Litigation and Administration, to William Henry, November 5, 1993; Letter From Barbara A. Clark, Director of Litigation and Administration, to Wayne D. Collins, November 5, 1993.

drug manufacturers to obtain the best prices for drugs to be included in the formulary. A large PBM can aggregate the purchasing power of smaller insurers and employers to obtain better prices.

A drug manufacturer's ownership of an entity that serves to drive down the price of drugs raises the obvious question whether the fox will be guarding the chicken coop. On the other hand, if this vertical integration is efficient, the theory of Alberta Gas would suggest that it might drive down consumer prices.

One school of thought is that a drug manufacturer might use its control over a PBM's formulary to exclude drugs made by competing manufacturers, in effect foreclosing them from a segment of the market. The suggestion has been made that the Commission should require the drug manufacturers that own PBMs to maintain so-called "open" formularies. In an open formulary, the PBM reimburses the pharmacy for any medication prescribed for a particular condition. In a "closed" formulary, the PBM reimburses only for drugs listed in the formulary, unless the physician has obtained prior approval to substitute an unlisted drug. Requiring open formularies would keep drug companies from excluding the products of other drug makers from the formulary.

Another school of thought is not concerned by this foreclosure and indeed regards exclusivity as an important proconsumer technique to obtain low prices. For example, pharmacy benefit plans sometimes limit the number of pharmacies that are allowed to participate in the network of pharmacies

approved to fill prescriptions under the plan. Some pharmacists have opposed such exclusive dealing and have sought state legislation to require that a plan deal with any pharmacy willing to adhere to the plan's terms. Such bills have been called "any willing provider" bills. Under the Federal Trade Commission's advocacy program, the staff of the Commission has opposed "any willing provider" bills on the ground that the legislation diminishes the incentives of pharmacies to compete to secure places in the network and, therefore, may drive up consumer prices.[22] Some might argue that the same principle should apply to governmental orders that PBMs must maintain an open formulary. I should note that although the Commission votes to authorize the staff to file comments such as these, the comments include an express disclaimer that they do not necessarily reflect the Commission's views. Reconciling these two schools of thought presents an interesting challenge for the Commission in evaluating vertical cases such as those involving PBMs.

Evaluating the competitive effects of vertical integration is not easy. On one hand, concern about drug makers' capture of the entities developed to control drug costs seems legitimate. On the other hand, exclusive dealing may be efficient, at least according to the Commission staff, and it would be anomalous to

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[22] Letter to The Honorable Roger Madigan, The Senate of Pennsylvania, on behalf of the staff of the Federal Trade Commission, April 19, 1993; Letter to The Honorable E. Scott Garrett, Chairman, Assembly Insurance Committee of the New Jersey State Assembly on behalf of the staff of the Federal Trade Commission, March 29, 1993.

impose an order that prevented the merging parties from attaining the potentially proconsumer efficiencies of vertical integration.

III.

Finally, I would like to talk for a moment about some recent Commission consent agreements that are somewhat novel, involving home oxygen suppliers. Home oxygen may be prescribed by physicians for patients with certain forms of lung and other diseases. Such patients are generally under the care of a pulmonologist and are frequently unfamiliar with home oxygen systems or with their suppliers. Not surprisingly, pulmonologists have the ability to refer patients to particular suppliers of home oxygen.

The Commission recently accepted consent agreements with two suppliers of home oxygen in the San Francisco Bay area and twenty-eight individual physician investors who owned an interest in the two suppliers. Home Oxygen & Medical Equipment Co., No. C-3530 (Sept. 14, 1994); Homecare Oxygen & Medical Equipment, No. C-3532 (Sept. 14, 1994); Certain Home Oxygen Pulmonologists, No. C-3531 (Sept. 14, 1994). Home Oxygen was located in San Leandro, California, and Homecare Oxygen was in Concord, California. Partnership interests in the two firms were offered to hospitals and pulmonologists, and sixty percent of the pulmonologists in each of the areas served by the two firms either were investors in the home oxygen firms or practiced with investors in those firms. The complaints alleged that through the aggregation of

pulmonologists, the two home oxygen supply firms aggregated market power in their respective geographic markets.

The theory of violation was that the ownership of a home oxygen supplier by the majority of pulmonologists in a particular market enables them to create barriers to entry (i.e., through patient referrals by the owner-pulmonologists and the resulting inability of other suppliers to obtain referrals). The remedy was to require sufficient divestiture that no more than 25 percent of the pulmonologists in a relevant market were affiliated with a single oxygen supplier. Although the evidence was sufficient to satisfy the statutory standard of reason to believe that the law had been violated, it provided precious little guidance on the desirability of establishing a new Commission policy.

During the public comment period in the Home Oxygen matter, counsel for the pulmonologists informed the Commission that the physicians had exchanged their partnership interest in the two oxygen companies for shares of stock in a major oxygen supply firm. The Commission majority decided that the transaction eliminated the need for divestiture. I dissented from the issuance of the final order, as modified, because the final order seemed to me to be inconsistent with the original theory of the case. The same group and number of referring physicians still retained an economic interest in a single oxygen supplier in the relevant geographic markets. Although the transaction may have altered somewhat their incentives to self-refer, the Commission

had no evidence on which to assess this possibility. The transaction did not reduce the market power of the group of pulmonologists in the relevant market, which seemed to be the premise of the original enforcement action.

My point today, however, is not to argue the merits of the revision of the home oxygen orders, but rather to point out that the modification suggests some confusion about the underlying theory of the case. This, in turn, raises the question whether it is a good idea for the Commission to announce new antitrust policy by accepting consent orders premised on new theories. Parties frequently sign a consent order at a relatively early stage in an investigation to avoid the expense and burden of defending an antitrust case. Although that motivation may be entirely sensible from the respondent's point of view, it may not lead to the best result from an antitrust policy perspective. The record in such a matter is frequently truncated, and the respondent may not have made any serious effort to explain the reasons for its conduct. In Chicago Professional Sports Limited Partnership v. National Basketball Association, 961 F.2d 667, 676 (7th Cir.), cert. denied, 113 S. Ct. 409 (1992), Judge Easterbrook observed that "[u]nderstanding novel practices may require years of study and debate," and that if the defendant has the burden of explaining his conduct, "ignorance leads straight to condemnation."

In many respects, the Federal Trade Commission is in an ideal position to provide the study and debate that Judge

Easterbrook seems implicitly to encourage. The Commission acts in the public interest, and private incentives do not control enforcement efforts. Under Section 5 of the Federal Trade Commission Act, the Commission has a degree of enforcement latitude that may not be available under other statutes.

To use the Commission's powers to challenge novel restraints wisely, we need to spend the time and we need to spend the resources to develop a full understanding of the conduct in question. We then should understand the legal, economic, and practical business ramifications of the conduct under scrutiny and have an equally thorough understanding of the consequences of antitrust intervention in the market. At that point, the explanation of any enforcement action should follow with relative ease.

The Commission has grappled with many of the difficult antitrust issues presented by modern distribution and marketing practices. We have initiated well founded actions against resale price maintenance. We have taken on the difficult task of evaluating the competitive effects of vertical mergers under Section 7 of the Clayton Act. We have not hesitated to use our authority under Section 5 of the Federal Trade Commission Act to challenge novel practices that pose risks to competition. I expect that as we continue into a new era, the Commission will redouble these and other important enforcement efforts.

Thank you.