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Demand-driven integration and divorcement policy☆

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Traditionally, vertical integration has concerned industrial economists only insofar as it affects market outcomes, particularly prices. This paper considers reverse causality, *from* prices – and more generally, from demand – *to* integration in a model of a dynamic oligopoly. If integration is costly but enhances productive efficiency, then a trend of rising prices and increasing integration could be due to growing demand, in which case a divorcement policy of forced divestiture may be counterproductive. Divorcement can only help consumers if it undermines collusion, but then there are dominating policies. We discuss well-known divorcement episodes in retail gasoline and British beer, as well as other evidence, in light of the model.

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1. Introduction

A regulator observes that the firms in an industry he suspects of being imperfectly competitive have been vertically integrating over time. Armed with the traditional tools of industrial economics, he reckons that either integration is occurring because it enhances the productive or allocative efficiency of the firms in the industry, or because the firms are attempting to enhance their market power. Efficiency gains can arise because integration or vertical restraints help the vertical chain to internalize some externalities (e.g., double marginalization or free riding by distributors), in which case prices ought to fall. Market power enhancement could be due to foreclosure (increase rivals' costs, refusal to supply) or to increased ability for vertical chains to collude; either way, prices should rise either at the wholesale or retail level.[1] Hence, theory suggests that integration may *lead* to higher or lower prices depending on whether the dominant effect is foreclosure or efficiency. Telling the difference is straightforward: if prices are falling with integration, efficiency effects predominate. If they are rising, likely the firms are succeeding in enhancing their market power.

In the case of decreasing prices, the regulator, whose main constituency is consumers, has little reason to be concerned. In the other case, though, the regulator might be tempted to invoke a divorcement policy in order to limit the apparent effects of integration, either by intervening in the control structure of the production chain (for instance by ordering franchise gasoline retailers rather than their supplying refiners to make pricing decisions) or, more drastically, by ordering asset divestitures (as in the forced sale of pubs by the brewers that own and supply them).[2] Being a practical person mainly interested in effective policy implementation, the regulator is not apt to ask the seemingly academic question of why integration has increased recently rather than some time in the distant past; the issue is how to act given the rise in prices. (In the case of falling prices, the regulator might take reasonable comfort in chalking it up to changes in the technology of production or distribution.)

But as is often the case, there are dangers in avoiding the academic questions. Indeed, in oft-studied cases in US retail gasoline and British beer, regulators imposed divorcement policies following long periods of increasing integration and rising prices. What ensued

[1] See e.g., Lafontaine and Slade (2007); Rey and Tirole (1997); Riordan (2005). On balance, the empirical literature tends to provide support for the efficiency effect of vertical integration or vertical restraints (Cooper et al., 2005; Lafontaine and Slade, 2008).

[2] The terms dissolution, divestiture and divorcement are often used interchangeably. The following excerpt from Oppenheim (1948) – cited in Adams (1951) – clarifies usage: "divestiture refers to situations where the defendants are required to divest themselves of property, securities or other assets. Divorcement is [...] used to indicate the effect of a decree where certain types of divestiture are ordered. It is especially applicable to cases where the purpose of the proceeding is to secure relief against anti-trust abuses flowing from [vertically] integrated ownership and control. The term 'dissolution' is generally used to refer to any situation where the dissolving of an allegedly illegal combination or association is involved, including the use of divestiture and divorcement as methods of achieving that end. While the foregoing definitions differentiate three aspects of remedies, the terms are frequently used interchangeably without any technical distinctions in meaning." We thank Yossi Spiegel for suggesting this reference.

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