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THE 1992 MERGER GUIDELINES: THE IMPORTANCE OF FACTORS OTHER THAN CONCENTRATION

Several appellate and district court decisions in recent merger cases have relied heavily on factors other than market shares and concentration. Perhaps the most important of these is the DC Circuit's Appellate decision in *U.S. v. Baker Hughes* in which the court relied on the ease of entry into the market alleged by the Department of Justice, the existence of large knowledgeable customers, volatile demand, and a number of other factors.

Consistent with the court decisions, the government's recently revised Merger Guidelines make it clear that, conceptually, factors other than concentration have an important role to play in merger analysis when the merger does not create a dominant firm. Unlike the 1984 Merger Guidelines, the 1992 Guidelines recognize the potential importance of these factors in all markets, not only in markets where the HHI is below 1800. This revision is consistent with the economics literature, which provides no support either for the existence of a single critical concentration level that applies to all markets or for a specific critical HHI level of 1800. The failure of the economics literature to identify a universal critical concentration ratio should not come as a surprise because markets differ in other important structural characteristics. Even a concentrated market can function competitively if it has structural characteristics that make coordination by sellers difficult.

To understand how non-share factors apply to a competitive analysis, it is necessary to understand why a particular firm might choose to cheat on a group agreement. Simply, a firm can be expected to cheat if it expects the cheating to be profitable. That is, a firm will lower its price if it expects to receive enough additional sales to compensate for the reduced margin. The level of lost sales needed for a particular price increase to be unprofitable for a firm is determined by the size of the price increase and by the firm's contribution margin. (See Barry Harris and Joseph Simons, "The Often-forgotten Role of Price-cost Margins in Antitrust Analysis," *International Merger Law*, February 1991.) Similarly, the same relationship between price and contribution margin identifies the amount of additional sales needed to make cheating profitable. When contribution margins are large, all else equal, cheating becomes more profitable and, thus, more likely.

Because differences in costs or in the demand facing different suppliers determine a firm's contribution margin, they also affect each firm's incentives to go along with a group attempt to raise price. When differences in costs or demand are large, a price increase that is profitable for a group of firms (i.e., the hypothetical monopolist) may not be profitable for each of the firms in the group. Unless they are compensated, firms that find the price increase unprofitable will not follow the group's goals, and the coordination necessary to raise price will not occur.

In effect, high concentration is necessary, but not sufficient, for the exercise of market power. Non-share factors apparently will play an important role in future mergers. The key to the appropriate use of non-share and non-concentration factors is to focus

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on how their existence affects the incentives of individual firms and how differing incentives among the firms affect the ability of the group to achieve the coordination necessary for the successful exercise of market power. Except in markets where this coordination occurs, a merger is not likely to lessen competition.

EI Principal Barry C. Harris was previously an economist at the Justice Department and the Interstate Commerce Commission. He has testified in numerous antitrust cases, including three merger cases: U. S. v. Calmar, FTC v. Occidental Petroleum, and U. S. v. Baker Hughes. *A more detailed discussion of this topic appears in the March 1992 issue of* International Merger Law.

NO MORE BLANK CHECKS FOR REGULATORS

A lack of effective regulatory oversight in the past has allowed the costs of new environmental, health, and safety regulation to far outpace the benefits that have accrued to the average consumer. In response to the rapid growth in the regulatory burden, the Bush Administration has implemented a "moratorium" aimed at improving the effectiveness of regulations. The moratorium calls for a review of existing regulations, directs that any new regulations be evaluated on the basis of benefits and costs, and encourages the use wherever possible of market-based mechanisms to achieve regulatory objectives. In addition, Federal agencies are required to develop plans for streamlining and improving regulations. Each of these actions helps address the growing national regulatory burden that is stifling economic growth and hindering international competitiveness.

Few regulations undergo assessments of their benefits and costs. Indeed, regulatory agencies often fashion regulations without regard to their cost. In some instances, such as listing species under the Endangered Species Act, the law specifically forbids cost considerations by regulators. This tends to produce regulations that yield no increased benefits to offset their negative impact on economic growth. The result is a regulatory burden on the economy now estimated at $400 billion per year. Moreover, new regulations tend to cost more while delivering less. For example, the cost of the 1990 Clean Air Act is estimated to exceed it benefits by about $16 billion annually.

The regulatory moratorium is an important first step in enhancing economic growth and competitiveness. It also provides an opportunity to apply to existing and proposed rules some basic tests such as: (1) is the risk addressed by the regulation sufficient to justify government action, (2) will the regulation produce a benefit greater than its costs, (3) is there a cheaper alternative that will produce an equally satisfactory result, and (4) does a regulation specify the objective in broad terms that encourage its attainment through the demonstrated efficiency, power, and ingenuity of the marketplace. The effectiveness of utilizing the market to achieve regulatory objectives in a least-cost manner has been demonstrated through a limited number of programs such as the recently enacted market-based initiative to control acid rain.

Sensible regulation should balance concern for the environment, health, and safety with concern for an economy that can provide jobs, a high standard of living, and the resources to address pressing public policy issues. What is often not recognized is the hidden threat to our economic vitality posed by our current form of command and control regulation. Just as government spending can adversely affect private investment, so too can government regulation. Regulatory costs could more easily be constrained if they were tallied up alongside budgetary expenditures. Regulations that lowered the standard of living should be made the exception rather than the rule by having the law require that benefit-cost tests be performed.

This article is adapted from an op-ed article in the NEW YORK TIMES *by EI Special Consultant Robert W. Hahn. Dr. Hahn is an expert in environmental and energy regulation, a Resident Scholar at the American Enterprise Institute and an Adjunct Research Fellow at Harvard University's Kennedy School.*

BEYOND DEREGULATION OF NATURAL GAS SALES

Through its Order 636, the Federal Energy Regulatory Commission (FERC) is continuing the transition of natural gas pipelines to an open access regime in which shippers purchase gas competitively while pipeline transportation remains regulated. FERC's general tendency toward loosening the regulation of competitive markets is likely to continue after Order 636 because some pipeline transportation markets (in addition to the markets for the gas itself) will become workably competitive. Indeed, FERC has established a task force to recommend a framework for analyzing competition in transportation markets, and both the Departments of Energy and Justice have been contemplating an industry-wide study of competition.

Even without Order 636, existing pipeline-to-pipeline competition is sufficient to find some pipeline transportation markets workably competitive—especially high volume markets. Even more markets may qualify when the competitive effect of potential new facilities is taken into account. Once FERC finds that no firm has market power in these markets, it could effectively deregulate these markets.

Order 636 creates more competitive markets. In particular, it grants shippers two rights that create a significant number of new competitive markets for pipeline transportation. First, it requires pipelines to allow shippers to resell pipeline capacity that they have under long-term contract and temporarily do not need, much as a renter with a long-term lease might sublet some property. This increases competition for existing capacity because shippers can purchase capacity from any long-term rights holder as well as from the pipeline. Second, the Order also requires that receipt and delivery points become more flexible. This increases competition because it allows transportation for one shipper to be transformed into transportation that can be used by another shipper by changing the receipt and delivery points. As a result, many long-term rights holders in effect become alternative sources of capacity.

Often these rights alone guarantee that existing capacity on a pipeline is efficiently allocated, assuring FERC that short-term markets are workably competitive. The capacity rights of most, if not all, pipelines are distributed so diffusely that neither the pipeline nor any shipper has market power from control of capacity. Pipelines may now present evidence of competitiveness to FERC, which may then effectively deregulate the pipeline and its shippers in these short-term markets (except for maintaining the competitive rights within the Order that have created the competition).

Going beyond the requirements of Order 636, pipelines may also create more competitive markets by granting all their shippers some competitive rights such as free backhaul or long-term capacity at new capacity prices. In fact, the post-Order 636 world may offer pipelines the opportunity to have FERC find *all* of its transportation markets—short-term firm and interruptible transportation, long-term firm transportation, and storage—workably competitive. If so, all of their markets could be effectively deregulated and rate hearings could be eliminated.

Currently, any looser regulation of competitive markets is likely only for those pipelines that voluntarily seek FERC action. From a pipeline's perspective, a voluntary proposal to effectively deregulate markets that will be competitive anyway under Order 636 will almost certainly be profitable and should be pursued. Profits rise because regulatory costs fall; they also rise because revenues increase when price is above cost-of-service rates (when capacity is scarce) and when the pipeline can customize services that add value at little cost. Prices do not fall due to deregulation because the discounting allowed when the market price is below the regulated rate makes them competitive already. A pipeline's ultimate insurance is that it can always withdraw its voluntary proposal to deregulate a market if it does not like the final result.

A pipeline may wish to propose effectively deregulating only some of the additional markets that become competitive from rights not required by Order 636. Here some losses are possible, and each pipeline must weigh the revenue gains discussed above against the revenues losses from otherwise captive shippers. While the answer may differ on different pipelines, the profit potential from effectively deregulating these markets should lead each pipeline to consider this option.

EI Senior Economist Dan Alger was previously Chief of the Industry Analysis Branch of FERC's Office of Economic Policy. He was also a Senior Economist at the Federal Trade Commission.

FERC'S ANALYSIS OF ANTITRUST ISSUES IN MARKET-BASED PRICING APPLICATIONS

On several recent occasions, the Federal Energy Regulatory Commission (FERC) has considered whether market-based rates for bulk power sales would be "just and reasonable" because there is no market power. In considering two applications for approval of long-term power sales at market-based rates, FERC relied on a flawed analysis of market power. (See *Terra Comfort Corporation and Iowa Southern Utilities Company, 1990,* and *TECO Power Services and Tampa Electric Company, 1990.*) An appropriate analysis of market power would identify every potential bidder with competitive costs whose ability to supply power to the purchaser is independent of the discretionary approval of another bidder. FERC, however, focused on the ability of power suppliers to "foreclose" other potential power suppliers by withholding access to their transmission facilities. FERC failed to consider whether the purchaser had sufficient alternatives to the winner's transmission facilities to discipline the winner's price. Not only were the factors considered by FERC insufficient to establish the existence of market power, they were not necessary for the exercise of market power.

FERC relied on a flawed analysis of market power in considering applications for long-term power sales at market-based rates.

The *Terra Comfort* rate application raised the antitrust issue of whether the applicants, either alone or in collusion with other entities, were likely to exercise market power in supplying power to the purchaser, Iowa Electric Power and Light. FERC concluded that the applicants had not demonstrated that they could not exercise market power. In reaching this conclusion, however, FERC did not carry out a traditional antitrust analysis. Furthermore, the record was incomplete on crucial factual issues relating to transmission access and other matters. These issues included the existence of five independent potential bidders and the possibility that self-generation by Iowa Electric could have prevented the exercise of market power.

The FERC majority also introduced the spurious foreclosure issue in its order. This confused the ability to foreclose a particular competitor with the ability to restrict competition in the market and exercise market power. Moreover, FERC did not establish that any of Iowa Electric's next best independent sources of power after the applicants depended on transmission by the applicants.

As in its *Terra Comfort* order, FERC's rejection of the proposed market-based prices in *TECO Power Services* was based on a faulty analysis of market power. FERC's most significant error was its failure to consider the ability of the purchaser (Seminole Electric Cooperative) to construct its own generation facility, an alternative that would have restricted the exercise of market power. Instead, FERC incorrectly focused on the possibility that a potential supplier of power might have been foreclosed from bidding for the Seminole contract because of a need for access to TECO's transmission facilities, even when no transmission interconnection existed between TECO and Seminole.

FERC's consideration of market-based rates for bulk power sales could potentially provide utilities with increased access to low-priced power. Unfortunately, in its effort to restrict the use of market-based rates to situations in which the winning seller of the power does not possess market power over the buyer, FERC has established flawed standards for evaluating whether market power exists. Among these is the potential foreclosure of competitors which FERC emphasized in its analysis. FERC's analysis is flawed because the conditions it considers are neither necessary nor sufficient for the existence of market power.

EI Principal Barry C. Harris has testified in numerous antitrust and regulatory proceedings involving market power issues. EI Senior Economist Mark W. Frankena testified on the competitive effects of the acquisitions of Public Service of New Hampshire by Northeast Utilities and Gulf States Utilities by Entergy. A more detailed treatment of this subject appears in the June 1992 issue of The Electricity Journal.