Economists Incorporated

Economists INK

SUMMER 2009

A BRIEF ANALYSIS OF POLICY AND LITIGATION

The CCC/Mitchell Decision and the Standards for Preliminary Injunctions Against Mergers

David D. Smith

David D. Smith has extensive experience in analyzing the competitive effects of mergers both at EI and in his previous position at the Antitrust Division of the Department of Justice.

The U.S. District Court for the District of Columbia recently issued a Preliminary Injunction (PI) to enjoin the merger of CCC Information Services (CCC) and Mitchell International Inc. (Mitchell). Both companies provide specialized computer software to estimate the repair costs or replacement value of vehicles involved in crashes.

The FTC sought the PI, stating that the transaction amounted to a 3-to-2 merger in the "partial loss and total loss software markets." The court found that the evidence was "more complicated and uncertain" than claimed by the FTC, but that the FTC had raised questions serious enough to warrant granting the PI. Two days after the PI was issued, the parties abandoned their deal.

One of the more interesting parts of the 85-page decision is the court's description of the PI standard that the FTC must meet. The decision follows a recent D.C. Court of Appeals decision in using a standard that is lower than many had expected. Section 13(b) of the FTC Act says that a district court can grant a PI if "weighing the equities and considering the Commission's likelihood of ultimate success, such action would be in the public interest." In the recent *Whole Foods* case, the D.C. Court of Appeals ruled that a district court considering granting a PI must use a sliding scale in balancing the likelihood of FTC success on the merits against the equities. Judge Brown of the Appellate Court wrote that because the equities often favor the FTC, the FTC could be entitled to a PI unless it has "entirely failed to show a likelihood of success."

In the CCC/Mitchell decision, the court repeatedly cited the *Whole Foods* decision when deciding to apply a sliding scale and issue the PI. Citing language from Whole Foods, the court stated, "A greater likelihood of the FTC's success will militate for a preliminary injunction unless particularly strong equities favor the merging parties.'" Further, the court said, "If the FTC meets its burden of showing that it is likely to succeed on the merits, it 'creates a presumption in favor of preliminary injunctive relief."

With two recent decisions favoring a sliding scale, it appears that this PI standard is gaining ground. Moreover, after these two favorable decisions, the FTC may find it easier to get PIs against mergers.

Is a Relevant Market Irrelevant?

Michael G. Baumann

A paper proposing a new method for the antitrust agencies to use in screening mergers between manufacturers of differentiated products was released last November by Joseph Farrell and Carl Shapiro, who soon after became chief economists at the FTC and DOJ Antitrust Division respectively. While the paper, "Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition," presents their personal views and does not necessarily reflect the official position of the agencies, it provides some insight into how the authors are likely to approach these types of mergers.

Farrell and Shapiro claim that a new screening mechanism is needed for mergers involving differentiated products because it may be hard for the antitrust agencies to define the relevant market and compute market shares following the methodology in the Horizontal Merger Guidelines. They argue that market boundaries are unclear when dealing with differentiated products and that what really matters is the proximity of the products.

Farrell and Shapiro suggest screening differentiated product mergers for anticompetitive effects using what they term upward pricing pressure (UPP). Under a unilateral effects theory of competitive harm, the merger gives the merged entity a unilateral incentive to raise price. UPP measures the incentive to raise price. It does not measure actual price changes, which depend on shapes of demand curves and responses of the other firms. The authors argue that actual price changes are too hard to measure to use in screening.

The key factors determining UPP are the merging firms' prices, marginal costs and diversion ratios. These are the same factors identified for determining unilateral effects many years ago. Before the merger, neither merging party would increase price because if it did, the loss of sales to other firms would make the price increase unprofitable. The diversion ratio is the share of those lost sales that would go to the other merging party. After the merger, that share of sales would be recaptured by the firm rather than lost. As a result, the merger would increase the incentive to increase price. The increase in incentives depends on the price-cost margin enjoyed by the other firm, which indicates how profitable it would be to recapture those sales, and the diversion ratio.

Michael G. Baumann has expertise related to modeling the effects of mergers. He has analyzed the likely competitive effects of mergers in a variety of industries.

For tractability, the authors assume a particular model of competitive behavior, Bertrand, and assume constant marginal costs and constant diversion ratios. Given these assumptions, the UPP is equal to price minus marginal cost multiplied by the diversion ratio. They assume that the results from their simplified model are not misleading – but the analysis does not necessarily accurately reflect all industries.

There will always be a positive UPP if the two firms have a positive price-cost margin and there is any substitution between their products. Recognizing that the screening mechanism cannot forbid all mergers with a positive UPP, Farrell and Shapiro propose incorporating some standard level of efficiencies into the analysis – a standard deduction. For example, any merger could be assumed to reduce costs by a given percent, say 5%. A merger would be presumed to raise prices if the UPP was greater than that percent times marginal costs.

The proposed methodology is not meant to determine the competitive effects of a merger but to provide an initial screening of mergers with possible unilateral effects and establish a level of presumptive harm that the merging parties would then have to overcome without the need to define a relevant market. Thus, it would replace the current practice of computing market shares, calculating the HHI, and determining if the merger falls into the range that raises significant competitive concerns and a presumption of enhanced market power.

The authors argue that it is easier to measure the price-cost margin and diversion ratio than to define a relevant market and compute market shares. But the variables used in the proposed screening analysis are not always readily observable and often have to be guesstimated. Because marginal costs are hard to measure, typically they are approximated by short-run variable manufacturing costs. The use of this proxy, however, may misstate the true price-cost margin. Available accounting data often will not reflect all economic mar-

continued on page 4

Investment Incentives and Merger-Specific Efficiencies

Richard T. Shin and Kwang Soo Cheong

The efficiencies potentially available from a merger may be an important factor both in the companies' decision to merge and in the antitrust authorities' decision whether to challenge the transaction. Efficiency gains will reduce costs and hence increase profits. Whether these gains will also reduce price and increase consumer welfare is another matter. In evaluating merger efficiencies, the antitrust authorities should recognize that improvements in investment incentives may be important efficiencies that increase consumer welfare.

This interest in consumer welfare has led the antitrust authorities to focus on efficiencies that reduce marginal costs. Reductions in fixed cost can also encourage investment and thus increase output and consumer welfare. Such efficiencies gains are likely to be cognizable under the revised Merger Guidelines. The Guidelines state that "certain types of efficiencies are more likely to be cognizable and substantial than others. For example, efficiencies resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the marginal cost of production, are more likely to be susceptible to verification, merger-specific, and substantial, or may be cognizable for other reasons." If a merger enables an expansion of capacity at one of the merged firm's facilities, that will enable production to be shifted to that facility. Such a shift in production may result in savings that are readily cognizable according to the Merger Guidelines.

The oil refining industry requires substantial fixed investments to increase capacity, and two merging oil refineries in Korea claimed increased investments would result in substantial efficiency gains. This claim was assessed using a game-theoretic model that specifically recognized the sequential nature of merger and investment decisions. The model was used to analyze the investment decisions likely to be made by market participants and then evaluate the total fixed cost for the market and the marginal cost for each firm both with and without the merger.

This modeling approach was applied to evaluate the merger-specific efficiencies from a proposed merger between the largest refinery in Korea, SK Corporation (SK), and the smallest refinery in Korea, Inchon Oil (ICO). This merger was subject to review by the Korea

Richard T. Shin has worked on a number of merger and price-fixing cases before the Korea Fair Trade Commission, including the SK-ICO merger. He has experience in demand estimation and merger simulation in various industries including energy, telecommunications, retail, manufacturing, health care, high-tech, and airlines.

Kwang Soo Cheong is an associate professor of the Johns Hopkins University Carey Business School and an affiliate with Economists Incorporated. He also worked on the SK-ICO merger.

Fair Trade Commission (KFTC), which is often said to judge merger efficiencies using standards that are comparable to those used by the U.S. authorities. SK planned to make substantial investments in ICO if the merger were allowed. Efficiencies resulting from these investments would be cognizable only if these investments would not take place without the merger. Therefore, a critical examination of efficiency claims should address the following questions:

- Would an alternative buyer invest in ICO in a way that would be similar to the planned investments by SK?
- Would SK make similar investments in other facilities were it unable to acquire ICO?

Alternative buyers would likely not have made the same investment in ICO that SK planned. The most likely alternative buyer for ICO's assets was a consortium of foreign investors. Those investors would make necessary investments to continue ICO's operations, but had no incentives to make a long-term strategic investment to improve ICO's refining capability or efficiency. The other possible alternative purchasers were the other oil refineries in Korea: GS Caltex, Hyundai Oilbank, and S-Oil; however, they expressed no interest in acquiring ICO. Any potential buyer except SK would have been reluctant to invest in ICO because there was already an overall excess capacity in oil refining for the Korean market. Compared to the other Korean refineries, SK had the largest network of foreign buyers and already had a presence in China selling refined products. SK projected that China's

continued on page 4

EI News and Notes

International Tribunal Adopts Proposed Remedy In Lumber Dispute

An international tribunal ruled for the United States in a dispute with Canada over the proper remedy for Canada's breach of the 2006 Softwood Lumber Agreement (SLA). The decision adopts a remedy laid out in the expert report of EI Principal Jonathan Neuberger. According to this remedy, Canada must collect an additional 10 percent export charge on its softwood lumber shipments from four eastern Canadian provinces until C$68.26 million has been accumulated. Jonathan Neuberger was assisted in the case by EI Senior Vice President Robert Stoner and EI Vice President Henry McFarland.

Oasis Pipeline Prevails in FERC Investigation

The Federal Energy Regulatory Commission (FERC) alleged that Oasis Pipeline gave undue preferences to a marketing affiliate and overcharged for transportation of interstate gas. FERC proposed to assess a civil penalty of $15 million and disgorgement of $267,122 in unjust profits. EI Principal John R. Morris testified that the alleged undue discrimination was a result of the Oasis dual contract program, dual contract holders were not similarly situated to other shippers, and Oasis did not overcharge for transportation of interstate gas. FERC later accepted a settlement with no admission of wrongdoing by Oasis, no civil penalty, and no disgorgement.

Reforming the Universal Service High Cost Fund.

EI Special Consultant Scott J. Wallsten testified before the House Energy and Commerce Committee, Subcommittee on Communications, Technology, and the Internet on reforming the universal service high-cost fund. Subsidies from the high-cost fund to rural telecommunications providers have increased from $1.7 billion in 1999 to nearly $5 billion today. Wallsten recommended moving from the current inefficient system to one that awards subsidies through competitive bidding. Such reverse auctions for universal service have been used successfully in other countries and could reduce subsidies and benefit consumers.

Is a Relevant Market Irrelevant?

continued from page 2

ginal costs, and that will result in overstating the measured margins and the UPPs.

The authors suggest using business documents, survey data, information about consumer switching patterns, econometric methods, or market shares to estimate the diversion ratio. Some of these methods require quantifying qualitative discussions. Others involve processing large amounts of data that may not be available during the screening process. Their suggestion that diversion ratios can be estimated based on market shares brings the analysis close to defining a relevant market. The authors claim that calculating market shares does not necessarily require doing so in a "relevant antitrust market" if all products in the "market" are about equally close substitutes for the product of the merging firm and if one can estimate the fraction of sales that would be lost to those firms in the "market" rather than to firms outside the "market." But determining to what alternatives a firm loses sales if it raises price comes close to defining a relevant market.

The proposed screen is likely to catch many mergers in its net. For example, if the standard deduction for efficiencies is 5%, there are 10 identical firms whose products are all equally substitutable, and when a firm raises price all lost sales go to other firms in the market, then a merger between any two firms would violate the screen if the price-variable cost margin were greater than 31%.

While the proposed screening mechanism creates a presumption of harm, this presumption can be overcome. The merging parties might be able to show that the estimated UPP is wrong because estimates of margins, diversion ratios, or efficiencies used by the agency are wrong. The parties also might show that the calculated UPP does not indicate any actual price increase because the basic assumptions of the analysis do not apply or because entry or repositioning will negate the UPP. Or the parties could do a full price effect analysis, which might show no anticompetitive harms.

The antitrust agencies probably will still define markets in investigations of differentiated product mergers. Nonetheless, the issues spotlighted in Farrell and Shapiro's paper are likely to become extremely important, now that they are the chief economists of the two antitrust agencies.

Investment Incentives

continued from page 3

demand for refined products would far outstrip Chinese domestic refining capacity. Thus, SK had greater incentives to invest in refining capacity in order to export to China as well as meet the domestic demand in Korea. Furthermore, in comparison with other potential buyers, SK's extensive experience acquired in the process of improving and updating its own refineries would be readily transferable to improve ICO's refineries.

Suppose SK was unable to acquire ICO. It is then unlikely that SK would have expanded refining capacity in its existing facilities. To increase its capacity, it must expand its existing facilities by acquiring adjacent real estate, and acquiring the necessary neighboring real estate was deemed to be prohibitively expensive. So, had SK invested in its own facilities, much of the investment would have gone to acquiring real estate, and the increase in productive capacity would have been much less than would have resulted from the same level of investment in the ICO facilities.

Therefore, acquiring ICO would allow a more profitable investment for SK than investing in its own facilities.

Besides the increase in capacity, other efficiencies would also result from SK's acquisition of ICO. SK could use its superior technical know-how to greatly enhance ICO's productive efficiency. Moreover, the use of SK's network for ICO products would reduce the cost of importing crude oil and exporting refined products. A substantial portion of these efficiencies would be marginal cost reductions that would be readily passed on to the Korean consumers.

In assessing the effects of a merger, it may be important to ask how the merger will affect investment incentives and the growth of industry capacity. A game-theoretic analysis of the SK's acquisition of ICO finds that the merger would put the acquired firm's assets in the hands of a company with greater ability and incentives to expand productive capacity than any other potential buyer, thereby generating cognizable efficiency gains. These efficiencies would likely reduce prices and increase consumer welfare. Largely because of these cognizable efficiencies and competitive constraints from the world oil market, the KFTC did not challenge the merger.

Economists INCORPORATED

OFFICES:

1200 New Hampshire Avenue, NW
Suite 400
Washington, DC 20036
[p] (202) 223-4700
[f] (202) 296-7138

5980 Horton Street
Suite 250
Emeryville, CA 94608
[p] (510) 547-6910
[f] (510) 547-5162

www.ei.com

President
Jonathan L. Walker

Editor
Henry B. McFarland

Layout
Gregory E. Wurz

in association with
The Allen Consulting Group in Australia