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Financial Analyses and Termination of the A-12 Aircraft Contract

By Jonathan A. Neuberger

In a ruling issued last summer, the U.S. Court of Federal Claims resolved in favor of the government, at least temporarily, the largest government contract dispute in history. That dispute pitted the U.S. Navy against two of the country's largest defense contractors. At issue was the disposition of a $4.8 billion contract to design and develop the A-12 attack aircraft. The Navy terminated the contract for default in early 1991, and the two sides have been involved in litigation ever since. As part of the litigation, the government performed financial analyses that raised serious doubts about the contractors' financial ability to complete the contract. These analyses included an in-depth assessment of the contractors' financial condition and performance, a detailed analysis of the contract's cash flows, and "but-for" projections of the financial impact of continued contract performance.

Under the terms of the full-scale engineering and development contract for the A-12, the contractor team of McDonnell Douglas and General Dynamics was to design, develop, build, and test eight aircraft for the U.S. Navy. The contractors were liable for any costs over the contract-ceiling price of $4.8 billion. When the Navy terminated the contract, the contractors had spent roughly $3.3 billion, had not produced a single aircraft, and by their own admission, were significantly over budget and behind schedule. The Navy alleged that the contractors' inability to specify when the contract would be completed, and how much it would cost, was instrumental to the termination decision.

The government argued that the termination was justified because the two companies had defaulted on their contractual obligations. The contractors' position, in contrast, was that the government terminated the contract for its own convenience. The government's default case included an extensive analysis of the contractors' financial capacity to complete the contract as originally structured. The government also argued that the contractors were unable to overcome technical obstacles to meeting the aircraft's specifications and that they were unable to meet contract deadlines.

The first of the three main avenues of financial analysis that supported the government's default case was largely descriptive. It involved a detailed assessment of the contractors' financial performance and condition during the period leading up to contract termination. This descriptive work included an analysis of contractor financial statements, a review of stock price behavior and analysts' reports, searches of trade publications and popular press, and a review of government financial reports. It also included in-depth analysis of recent financing activity by the contractors, as well as an assessment of available financing options. The descriptive analysis revealed that McDonnell Douglas was in serious

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Market Definition in the SunGard/Comdisco Transaction

By Barry C. Harris

Recently, a U.S. District Court ruled against the U.S. Department of Justice in concluding that SunGard's acquisition of the computer disaster recovery services assets of Comdisco, Inc. was not likely to harm competition. In their prevailing arguments, the merging parties maintained that shared "hot-site" disaster recovery services was not a properly defined product market. One unusual aspect of the market definition analysis in this matter was the impact of significant customer switching costs on an otherwise routine application of a Critical Loss analysis. The market definition analysis also took into account the possibility of separate markets stemming from price discrimination.

A disaster recovery hot-site is a computer facility that enables users to restore failed computer operations at a remote site. According to the Department's allegations, restoration usually must be accomplished within 16 to 96 hours. The Department alleged that users of outside vendors for hot-site services were limited to only three major suppliers of the service, two of which were SunGard and Comdisco. The main axis of contention between the Department and the merging parties was whether a properly defined market was limited to outside vendors of hot-site services. The defendants maintained that the Department's alleged market did not reflect market realities, principally because most computer disaster recovery is performed without using an outside vendor. In support of its alleged market, the Department argued that it is less costly to use shared hot-site services than to provide the service internally. The defendants countered that most customers had close alternatives to hot-site services available. These alternatives ranged from "high availability" and processing at the fast end of the recovery continuum to quick-ship and mobile options at the slower end. The court evidently did not find the Department's arguments to be persuasive. It cited quick-ship and internal options as close substitutes to shared hot-site services.

The court also identified the Critical Loss associated with shared hot-site services and the ability to price discriminate among customers as important issues. By their nature as a shared service, hot-site services have low variable costs, high variable contribution margins and a low Critical Loss. Specifically, the Critical Loss associated with a 5% price increase was calculated to be 5%. With most switching from SunGard's and Comdisco's hot-site services going to internal solutions, it was likely that lost sales in the event of an above-competitive price increase would exceed the Critical Loss.

The analysis of customer switching patterns revealed a strong customer preference for retaining current providers of disaster recovery services. Industry experience indicated that a 5-10% price difference was generally necessary before customers were likely to switch providers, even among the three major suppliers of shared hot-site services. This incumbent advantage was attributed to start-up costs such as the need for customers to retrain personnel when a new hot-site provider is chosen. The existence of high variable margins associated with hot-site services means that incumbents are willing to accept less than apparently profit-maximizing prices in order to ensure that customers would not switch providers.

The incumbent advantage also meant that the 5-10% price test that is typically associated with the Merger Guidelines needed to be adjusted to incorporate the added costs of switching. Thus the Critical Loss analysis needed to focus on price increases in excess of the incumbent advantage. The testimony of the Department's fact witnesses, however, was limited to a lack of likely switching away from shared hot-site services if prices rose 5-10%. It did not address whether the lack of switching also applied among hot-site providers, which contributed to the Department's inability to establish its alleged hot-site services market.

While switching to quick-ship and internal alternatives precluded a general market for hot-site services, a more narrow, targeted market based on price discrimination required consideration. As the Merger Guidelines recognize, such a market would require SunGard to be able to distinguish between customers that would and would not switch from hot-site services. If SunGard could make this distinction, it could avoid lost sales associated with an across-the-board price increase by limiting higher prices to customers unwilling to switch. Unless there is a well-defined, identifiable group of captive customers, however, attempts at price discrimination will still involve lost sales (and lost profits) as misidentified customers switch to alternatives. Consequently, an alleged market based on price discrimination must still pass a Critical Loss test. An analysis of customers by industry, size, location and type of computer failed to identify any group that did not already include customers meeting their disaster recovery needs without using shared hot-site services. Consequently, all customers could credibly threaten to use these alternative services, which in turn means that the appropriate antitrust market to evaluate the SunGard/Comdisco transaction needed to include quick-ship and internal alternatives. When these alternatives were included in the analysis, it was clear that the SunGard/Comdisco transaction posed no threat to competition.

Principal Barry C. Harris testified at trial on behalf of SunGard. He has testified in six other merger trials opposing the government including Baker Hughes, Mercy Health Services and Tenet Healthcare.

Supply Margin Assessment: FERC's New Market Power Screen

By John R. Morris

Each year the Federal Energy Regulatory Commission (FERC) evaluates hundreds of requests by electric power generators to sell electricity at market-based rates. Market rate authority is granted whenever a generation company lacks "market dominance" so that sales would be priced at a "just and reasonable" rate. For almost a decade, FERC has used the so-called hub-and-spoke methodology to evaluate whether a generation company lacked market dominance. Recently, FERC replaced its hub-and-spoke methodology with a new Supply Margin Assessment (SMA) methodology. Yet FERC's use of SMA is inconsistent. It fails to apply SMA in areas in which it may have merit and applies SMA in markets in which it has none.

"FERC's use of SMA is inconsistent. It fails to apply SMA in areas in which it may have merit and applies SMA in markets in which it has none."

The hub-and-spoke methodology is a traditional market share approach to determine whether a generation company is "dominant" and thus might exercise market power. Suppose, for example, that electric utility A, the hub, is connected to utilities B, C, D and E, and that each utility has 100 MW of generation. Under hub-and-spoke, A's market would include its generation capacity plus all the generation capacity of B through E. Thus A's market share would be 20 percent. Market shares as high as 28 percent were considered not to be dominant; therefore, A would be allowed to charge market-based rates.

SMA makes three adjustments to the hub-and-spoke methodology. First, SMA limits potential imports to the amount that could actually be imported through the transmission system. Second, SMA limits potential imports to the generation that is uncommitted under peak demand conditions. Third, SMA replaces the market share screen with a supply margin assessment. The supply margin is the difference between available supplies and peak demand. The supply margin is then compared to the amount of generation owned by each generation company. If a company owns more generation than the supply margin, it is considered a "pivotal" or "dominant" supplier and market rate authority would not be granted for that market without mitigation.

FERC stated that it would apply SMA only in areas without Commission-approved market monitoring and mitigation. In essence, FERC will not apply SMA in areas like California, PJM Interconnection, and New England because those areas have FERC-approved central power exchanges, but will apply SMA in regions like the Midwest and Southeast that do not.

This application of SMA is not supported by economic analysis. SMA is most appropriate in deregulated power markets in which merchant plants do not have long-term obligations to sell power. SMA seeks to identify situations in which a generation company may be able to charge above-competitive prices because customers are forced to purchase from the generation company. A stylized example illustrates how a company could charge above-competitive prices. Suppose a generation company with 20 MW of uncommitted power knows the system operator needs 100 MW of generation and that other suppliers collectively have only 90 MW. In this case, the generation company's 20 MW is greater than the supply margin of 10 MW, which enables the generation company to charge above-competitive prices for at least 10 MW of its generation. The best real-life example of this theory comes from California. It is alleged that when supplies were tight, some generation compa-

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Selected EI Cases

Yellow Book USA v. Broadwing and Cincinnati Bell Telephone

Principal Stephen E. Siwek, who was assisted by Senior Economist Gale Mosteller, submitted testimony before the FCC's Market Disputes Resolution Division regarding a complaint that Cincinnati Bell Telephone overcharged for telephone subscriber listings. Working with Willkie Farr & Gallagher on behalf of a directory publisher, he explained that Cincinnati Bell's cost study failed to justify its rate. The study did not adhere to the requirements in the relevant FCC Order, overstated costs, relied on unverifiable components, and over-recovered costs shared by various services. Siwek recommended that Cincinnati Bell charge no more than 4 cents per listing, a price at which the defendants agreed to settle.

Exclusive Wholesale Beer Distribution Territories Hearing

Principal William C. Myslinski testified on behalf of the Beer Institute before the Indiana Alcohol and Tobacco Commission regarding exclusive wholesale territories for beer distribution. Indiana was the only state that did not have exclusive wholesale distribution territories. Myslinski explained that interbrand competition was sufficient and that exclusive territories provide incentives to develop the marketplace on behalf of the manufacturer. The Commission voted unanimously to allow the prohibition on exclusive territories to sunset.

Financial Analyses . . . (Continued from Page 1)

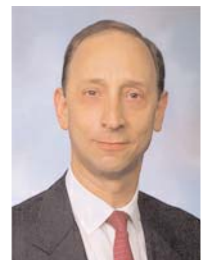
financial distress during the period leading up to contract termination. The company was spending billions of dollars to develop a new commercial aircraft and had limited financial capacity to absorb additional expenses (like those associated with A-12 cost overruns). While General Dynamics was in better financial shape, it too was reporting losses that weakened its financial condition.

The second avenue of financial analysis involved modeling the cash flows from the A-12 contract. Government contracting rules can be arcane, especially for a complex project like aircraft design and development. Accordingly, the cash flow model reflected applicable government contracting rules as well as characteristics specific to the A-12 program. The model incorporated contractor "burn rates," regular progress payments, loss-ratio provisions, and contract delivery schedules. The cash flow model was an essential building block for identifying the contractors' financing requirements under the A-12 program.

The third avenue of financial analysis was the most complex–development of a framework for analyzing the "but-for" world in which the contract was not terminated, but instead continued as originally structured. Such a framework was at the heart of the financial default case because it provided a tool for assessing the financial impact on the contractors of continuing to perform an over-budget fixed-price contract. The but-for framework started with detailed contractor financial statements, which were the basis for pro forma projections incorporating ongoing A-12 revenues and expenses. This model also reflected the constraints imposed by the contractors' various credit agreements. The projections were accomplished by interacting the financial model with the A-12 cash flow model using the contractors' own assumptions. The results were striking: under a conservative set of assumptions, continued performance of the original A-12 contract would have pushed at least one of the contractors into a serious financial crisis, perhaps even bankruptcy. Financial default was likely.

The financial review of the A-12 contract included both simple analyses and complex modeling. This combination helped to bolster the government's multi-pronged default case. The ultimate disposition of this case awaits the contractors' appeal of the Court's ruling.

Vice President Jonathan A. Neuberger performed the financial analyses and testified for the government in the A-12 litigation. He has also testifed and consulted for the government in several Winstar cases. He focuses on finance and intellectual property matters, as well as commercial damages.



Supply Margin Assessment . . . (Continued from Page 3)

nies in California shut down plants or did not bid them in the power exchange in order to obtain higher prices from their remaining plants.

A combination of tight supplies and generation companies with no prior commitment to operate generation capacity–a circumstance most likely to occur in deregulated power markets–thus raises a potential market power problem. Yet it is in these situations that FERC has stated it will not apply SMA, relying instead on market monitoring mechanisms that are already in place.

FERC also errs in applying SMA in more traditional markets in which it is seldom appropriate. Utilities in traditional markets must operate generation to meet their requirements to serve retail customers. In these areas, SMA is likely to identify companies whose generation is necessary, but whose generation will operate anyway in order to meet regulatory and contractual commitments.

SMA is also inappropriate in traditional markets because the amount of demand potentially subject to market-based rates is typically quite small. In most traditional areas, only wholesale demand, which is typically less than 10 percent of total demand, is open to competition and subject to FERC jurisdiction. In such circumstances, it is irrelevant that a generation company's capacity must be used to meet total demand. What matters is whether the generation company's capacity is necessary to meet the wholesale demand open for competition. If potential imports plus wholesale customers' generation is greater than wholesale customers' demand, then the utility attempting to make sales–even if it is "dominant" in its own area under SMA–must compete with other supplies. In other words, SMA finds dominance in traditional markets when none exists.

FERC is currently reviewing how it screens for potential market power and it may replace or revise SMA. For now, however, consumers and utilities are stuck with a market power screen that is unsupportable by economic analysis.

Senior Vice President John R. Morris leads the energy practice at EI. He has submitted several SMA's since FERC adopted the SMA methodology in 2001.

Economists Incorporated

Suite 400
1200 New Hampshire Ave.
Washington, DC 20036
Phone: (202) 223-4700
Fax: (202) 296-7138

Suite 250
5980 Horton Street
Emeryville, CA 94901
(510) 547-6910
(510) 547-5162

Website: www.ei.com

President, Bruce M. Owen; Editor, David A. Argue
Layout, Crystal D. Simpkins

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