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Merger Guidelines to Be Reviewed

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Lona Fowdur recently joined Economists Incorporated after completing her Ph.D. in economics at Cornell University. Her work at EI has focused on antitrust analysis in the energy and health care industries.

The Department of Justice and the Federal Trade Commission recently began a review of the 1992 Horizontal Merger Guidelines. The purpose of the review will be to incorporate advances in economic thought and analytic methodology in the Guidelines and to ensure that the Guidelines reflect changes in agency practice and legal precedent that happened in the past seventeen years.

The review will begin with a series of public workshops on the Guidelines. While the Agencies are open to suggestions on every aspect of the Guidelines, their main concerns are indicated by twenty questions that they released for comment. The Agencies have identified three broad areas that the review will focus on: market definition, market concentration and competitive effects.

In regards to market definition, the questions address the possibility of refining the hypothetical-monopolist approach and changing how critical loss analysis is performed. Comments are also invited regarding whether product markets should be defined on the basis of a collection of product substitutes versus successive consideration of "next-best" substitutes, and whether geographic markets should be based on the location of consumers rather than, or in addition to, that of producers. Further, the size of the price increase used in the hypothetical monopolist test will be reviewed.

Questions addressing market concentration concern possibly reevaluating the Guidelines' HHI thresholds. The Agencies may also expand the discussion of how market shares are measured and interpreted. A particular concern is the significance of market concentration in cases involving unilateral effects and in markets with significant technological change.

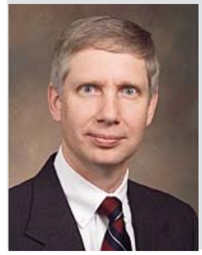
Competitive effects related questions center on incorporating advances in the treatment of unilateral effects, including the case of markets with localized effects and auction mechanisms. The agencies also will consider the use of merger simulation models and the use of market shares as a proxy for diversion ratios. Additional questions concern price discrimination, price effects on large as opposed to small buyers, and non-price effects.

Some further questions elicit comments on the failing-firm section of the guidelines and on whether the Guidelines should discuss partial acquisitions and merger remedies. Also considered is the value of relying on illustrative examples, retrospective merger studies, natural experiments and customer surveys to predict competitive effects.

Whether the review will ultimately result in a thorough overhaul of the Guidelines or just a few minor changes is uncertain. Nonetheless, the review will have significant implications for merger policy.

FERC Changes Its Approach in Two Price Manipulation Cases

John R. Morris



Principal John R. Morris leads the energy practice at EI. He testified on behalf of Energy Transfer Partners before FERC, and he often testifies concerning pricing issues in electric power and natural gas markets.

The Federal Energy Regulatory Commission (FERC) recently reached settlements in two high-profile cases alleging price manipulation in natural gas markets. These settlements likely reflect a more reasoned approach at FERC toward allegations of price manipulation. In *Amaranth Advisors L.L.C. et al.*, FERC and the Commodity Futures Trading Commission (CFTC) jointly accepted a settlement of $7.5 million in civil penalties. In *Energy Transfer Partners et al.*, FERC accepted a settlement of $5 million in civil penalties and a $25 million fund to disgorge alleged unjust profits to parties filing claims. Energy Transfer had earlier reached a settlement with the CFTC for $10 million.

These settlement amounts, although substantial, are much less than FERC originally sought. In July 2007, in the Amaranth case, FERC sought civil penalties of $200 million and disgorgement of $59 million in unjust profits plus interest. In 2008, the Commission turned down a proposed settlement because the civil penalties were not large enough given the alleged unjust profits. Also in July 2007, in the Energy Transfer case, FERC sought $82 million in civil penalties and disgorgement of $67 million in unjust profits plus interest. In litigation, FERC staff increased its estimates of the alleged unjust profits to $80 million.

In addition to the timing and the fact that FERC accepted much less money than it originally had sought, the cases had other similarities. Both cases dealt with allegations that the companies held positions in a derivative instrument that gave them an incentive to sell natural gas at lower prices. Amaranth was short in derivative NYMEX look-a-like contracts that settle based upon NYMEX future price settlements. FERC alleged that Amaranth sold NYMEX future contracts during the settlement period at artificially low prices in order to reap gains on the look-a-like contracts. Energy Transfer was short in derivative Houston Ship Channel (HSC) basis swaps that settle based upon monthly gas prices at HSC. FERC alleged that Energy Transfer sold physical gas at HSC at artificially low prices to reap the gains on the derivative basis swaps. Hence, both cases dealt with allegations of companies selling natural gas at lower prices, not higher prices.

Both cases also did not involve any trading behavior that is per se objectionable. A number of trading activities are clearly considered to be manipulative and are generally forbidden. For example, cornering a market—that is, controlling all of the potentially deliverable supplies for a futures contract—can allow a trader to sell at artificially high prices. Such behavior is recognized as manipulative, and specific rules are designed to prevent it. But FERC did not allege that either Amaranth or Energy Transfer did anything that was manipulative by itself. In fact, if Amaranth and Energy Transfer had not held short positions in derivative instruments, FERC would have had no objection at all. FERC also did not claim that Energy Transfer sold at a loss, or in other words that the revenue received from selling the gas was less than the cost of supplying the gas. Nor did FERC claim that Energy Transfer violated any trading rules. Furthermore, the respondents in both cases showed that other traders at other locations or in other periods exhibited generally similar trading behavior.

Both cases involved the effects of hurricanes Katrina and Rita. Although the Energy Transfer case ultimately led to allegations involving trades that occurred in 17 months of a 25-month period, the investigation originated with a single complaint about trading on September 28, 2005 and the vast majority of the alleged effects occurred from September through December of 2005. This period is when markets were in the most turmoil due to the hurricanes and their aftermath. During such periods, it is not surprising to have substantial and unexpected changes in prices. FERC's case amounted to claims that prices should have increased more in Texas immediately after the hurricanes, and prices should have remained high in December 2005 despite the post-hurricane recovery. The Amaranth case dealt with trading in March, April, and May 2006. In these months, prices were generally falling as gas supplies continued

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Assessing Monopolization Claims in the Face of Innovation

Barry C. Harris, Laura A. Malowane, Matthew B. Wright

To prove a monopolization claim under Section 2 of the Sherman Act, plaintiffs need to establish a) the possession of monopoly power in the relevant market and b) the acquisition or maintenance of such power through anticompetitive conduct, rather than as a result of superior skill or business acumen. The first element requires a substantial degree of market power—defined in economics as the ability to charge prices above competitive levels—and the durability of such power. The second element ensures that firms are not punished for competing successfully on the merits. Together, the two elements protect competition while allowing firms to reap the rewards of successful innovations that produce better products, lower costs, and greater consumer welfare.

The U.S. District Court for the Southern District of New York recently issued a decision that demonstrated these principles in *In re Fresh Del Monte Pineapples Litigation.* The case involved new hybrid "gold" varieties of pineapple, which differ from the Champaka pineapple variety that once dominated U.S. sales. The gold pineapples are sweeter, have a higher Vitamin C content, and have a golden shell color. A research cooperative called the Pineapple Research Institute began to develop one such hybrid variety, and in the 1980s it released plant material for this variety to its members, one of which was Del Monte. While other pineapple producers continued to focus on traditional pineapple varieties, Del Monte conducted experiments for over a decade to develop and test the new variety and determine that it would be suitable for commercialization. Del Monte's decision to commercialize the new hybrid variety involved substantial risks. Pineapple plants grow slowly, and each plant yields just one pineapple per growing cycle, so it takes a long time to develop enough plants to allow widespread sales of a new variety. Moreover, production of pineapples in general, and new varieties in particular, presents significant agronomic challenges. New varieties also present marketing risks, as producers cannot be certain about their level of consumer acceptance. Adding to the inherent risk in growing and marketing the new hybrid

EI Principal and Board Chairman Barry Harris submitted a declaration and provided deposition testimony on behalf of Del Monte in this matter. EI Principal and Corporate Vice President Matthew Wright and EI Vice President Laura Malowane assisted with the analysis. All three have extensive experience in analyzing monopolization claims.

was Del Monte's decision to convert rapidly its production from the Champaka variety to the hybrid variety. This decision required Del Monte to destroy productive Champaka plants to use the land to grow the hybrid variety.

Del Monte was the first to market the hybrid variety, which it designated the MD-2, when it introduced the new product under the Del Monte Gold Extra Sweet brand in May 1996. Del Monte's MD-2 pineapple was an enormous commercial success, and Del Monte's introduction of the new variety transformed the marketplace for fresh whole pineapples. In the decade after Del Monte introduced the MD-2, gold pineapples largely supplanted traditional Champaka pineapples in sales of fresh pineapples. Notably, Del Monte's innovation also led to significant increases in output, as fresh pineapple consumption roughly doubled in the United States during this time. As a result of its successful innovation, Del Monte achieved a leading share of fresh, whole pineapples within just a few years after the MD-2's introduction.

In 2004, a class action complaint was filed alleging that Del Monte violated Section 2 of the Sherman Act by improperly obtaining and maintaining a monopoly over the propagation, marketing, and sale of fresh, whole, extra-sweet pineapples. Among other claims, the plaintiffs alleged that Del Monte improperly delayed its competitors' entry into gold pineapples by issuing threatening letters to Costa Rican seed laboratories that were propagating MD-2 plant material and

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FERC Changes Its Approach

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to recover after the hurricanes. Hence, it would not have been surprising to have lower prices when Amaranth sold its futures contracts, regardless of Amaranth's behavior.

Finally, both cases involved causation issues that cast significant doubt on FERC's allegations. The alleged manipulative selling behavior may not have caused the actual transaction prices. For example, Energy Transfer used similar selling strategies in many months. FERC alleged manipulation in some of those months, but not in others. What caused the difference in prices between the allegation months and the non-allegation months? If it was not a difference in selling strategies, then the difference must be the result of other supply and demand factors. And if the other supply and demand factors are determining the prices, how can it be that Energy Transfer manipulated the prices? A seller that cannot cause actual transaction prices to be different cannot be said to sell at artificially low prices. Similarly in the Amaranth case, it is not clear that Amaranth's behavior reduced prices. Indeed, despite Amaranth's sales, prices in one month actually rose during half of the period in which contracts settled.

The settlements reflect a change at FERC. The Amaranth settlement apparently was available in 2008 when Staff and Amaranth reached an agreement that was rejected by FERC. FERC also might have settled earlier with Energy Transfer. Trade press reported in 2006 that Energy Transfer was willing to settle, and in 2007 Energy Transfer reached a settlement with the CFTC over allegations about trading in September and November 2005.

The reason for FERC's change in position is not clear. It is possible that additional litigation and discovery revealed weaknesses in FERC's allegations that were not previously apparent to FERC (but apparent to Amaranth and Energy Transfer). It is also possible that the new administration decided not to pursue further allegations against companies charging relatively low prices when energy prices were at historically high levels. Regardless, the settlements indicate FERC's willingness to put legacy cases behind it and move on to a new agenda.

Assessing Monopolization Claims

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by pursuing sham litigation. The plaintiffs alleged that as a result, Del Monte unlawfully obtained monopoly power and used this power to charge supracompetitive prices for its gold pineapples.

The District Court recently rejected the arguments of the plaintiffs and its experts and granted summary judgment to Defendant Del Monte. Notably, the Court rejected the plaintiffs' claims that Del Monte's conduct improperly delayed its competitors' entry. Rather, the evidence indicated that Del Monte's competitors had business reasons, unrelated to Del Monte's alleged actions, for delaying their own entry into gold pineapples. The Court cited evidence that some of Del Monte's competitors were concerned about the risks associated with production and marketing of gold pineapples and did not commit to the new varieties until Del Monte had demonstrated its success in producing and marketing them. Other competitors had a different corporate focus, and likewise decided to enter only after the success of Del Monte's gold pineapples became apparent.

The plaintiffs sought to buttress their Section 2 claims by asserting that Del Monte "achieved a huge operating profit to sales ratio . . . in its Gold business unit." The Court discounted such evidence, and there are sound economic reasons for it to have done so. It is inappropriate to draw conclusions about monopoly power based on the level of accounting profits associated with a single risky investment. Such investments, when successful, will tend to earn a risk premium and will naturally have margins that exceed those for other "competitive" benchmarks. Moreover, it is reasonable to expect that the profitability of Del Monte's gold pineapple operations would have persisted while its competitors sought to emulate Del Monte's success. The evidence indicates that Del Monte believed it had a competitive advantage by virtue of its having started to commercialize the MD-2 years ahead of other companies. The first-mover advantage would reasonably have allowed Del Monte for a time to earn a premium price and achieve lower production costs because of its more extensive experience with gold pineapples.

Del Monte's experience with gold pineapples demonstrates that firms that take risks and successfully innovate can earn substantial rewards while simultaneously increasing output and enhancing consumer welfare. Moreover, substantial profits and high market shares can persist for a time for innovative companies, even in the absence of significant entry barriers or exclusionary conduct.

EI News and Notes

Blue Cross Blue Shield of North Carolina Wins Summary Judgment

Barry C. Harris, EI Principal and Board Chairman, was the expert economist and testified at deposition on liability and damages on behalf of defendant Blue Cross Blue Shield of North Carolina (BCBSNC). The principal allegations by plaintiffs involved BCBSNC's refusal to include them in the provider networks for its commercial health plans. Plaintiffs claimed that BCBSNC used its alleged market power to foreclose and eliminate competition in Mecklenburg County. Dr. Harris's analysis showed that BCBSNC had no market power, foreclosure had not occurred, competition had not been eliminated and the appropriate antitrust geographic market was broader than Mecklenburg County. Plaintiffs' antitrust claims were dismissed. Williams Mullen PC represented BCBSNC. Dr. Harris was assisted by EI Vice President Stephanie Mirrow.

Ormco Corporation Settles Patent Infringement Suit Against Align Technology

EI Senior Vice President Richard Shin and EI Vice President Gale Mosteller assisted Ormco Corporation in its patent infringement suit against Align Technology. They worked with attorneys from London & Mead, one of the law firms representing Ormco. After the court had found Align guilty of infringement, Drs. Shin and Mosteller analyzed Align's opposition to an injunction that would have stopped Align from selling the Invisalign System during the remaining term of Ormco's patent. Shortly after the submission of EI's report, the parties settled the lawsuit.

Copyright Industries Report Released

The International Intellectual Property Alliance (IIPA) released *Copyright Industries in the U.S. Economy: The 2003-2007 Report*, which was written by Stephen E. Siwek, an EI Principal. This IIPA report reflects the recommended statistical standards developed by the World Intellectual Property Organization (WIPO) in 2003. It is the twelfth economic report that Mr. Siwek has prepared for the IIPA since 1990. The Report shows that the U.S. copyright industries continue to outperform other U.S. industries, in terms of their real annual growth rates and their contribution to overall economic growth.

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