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A BRIEF ANALYSIS OF POLICY AND LITIGATION

FTC Administrative Law Judge Rules that McWane Excluded Competitors but did not Fix Prices

David D. Smith

EI Vice President David D. Smith has dealt with antitrust issues in a wide range of industries. Before joining EI, he was an economist at the Antitrust Division of the U.S. Department of Justice.

The Chief Administrative Law Judge at the Federal Trade Commission (FTC) recently released his Initial Decision on *In the Matter of McWane, Inc. and Star Pipe Products Ltd*. He found that the FTC did not prove a conspiracy among the three Defendants to raise and stabilize prices or exchange sensitive competitive information, nor did the FTC prove that an "invitation to collude" had been issued. The Judge did find that two Defendants had committed exclusionary acts.

The relevant product market with regard to the collusion counts was ductile iron pipe fittings (fittings). The relevant product market with regard to the exclusion counts was fittings for projects that required domestically-produced products (domestic fittings). Ductile iron pipe is used for pressurized water distribution and treatment systems, and is generally sold to municipal buyers through a bidding process. The relevant geographic market for both products was the United States. Three companies – McWane, Sigma Corporation (Sigma), and Star Pipe Products, Ltd. (Star) – account for almost all U.S. sales of fittings. Only McWane supplies a full line of domestic fittings in the most commonly used size ranges. The Judge determined that both markets have high barriers to entry.

The Judge found that the Defendants' parallel conduct with respect to pricing, discounting and participation in a trade association was no more than legal "oligopolistic conscious parallelism." He found that McWane, Sigma and Star acted independently and competitively and did not discuss prices among themselves.

The Judge did find McWane and Sigma guilty of exclusionary conduct. He found that McWane had 95 percent of the domestic fittings market, and that it used its "Full Support Program" as an exclusive dealing policy to keep Star from entering the market. This program involved rebates to purchasers of McWane's full line of domestic fittings. Star did not sell a full line, and the Judge found that the program induced most customers to make all their purchases from McWane.

Moreover, McWane's Master Distribution Agreement (MDA) with Sigma was found to be anticompetitive. The MDA caused Sigma to drop its plans to enter the domestic fittings market. In addition, Sigma and McWane were found to have conspired to use the MDA to exclude Star from that market, because Sigma helped enforce McWane's Full Support Program.

McWane argued that its Full Support Program enabled it to lower average costs by filling its foundry capacity. The Judge concluded that this supposed benefit did not justify a program with significant anticompetitive effects.

Also In This Issue

The Use of Simulations to Assess the Effect of Vertical Mergers

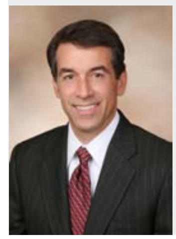
Michael G. Baumann and Matthew B. Wright describe the recent use of simulation models in the Justice Department (DOJ) analysis of a vertical merger. As is often the case with vertical mergers, the risk of input foreclosure was a significant focus of this merger investigation. Both DOJ and the merging parties used simulation models to analyze the merger's competitive effects. When merger-specific efficiencies were accounted for, the parties' model suggested that under most scenarios average prices to consumers would fall after the transaction. DOJ allowed the merger to proceed. While simulation models may help focus merger analysis, it is important to understand their limitations and to ensure that the assumptions that underlie any model are well suited to the merger being analyzed.

DOJ and AT&T Dispute Rules for Spectrum Auctions

Henry B. McFarland reviews the ongoing debate over how the Federal Communications Commission (FCC) should auction low-frequency spectrum. The U.S. Department of Justice (DOJ) fears that the largest wireless carriers, AT&T and Verizon, will purchase large amounts of spectrum in the upcoming auctions to foreclose their competitors and reduce competition in wireless markets. It is urging the FCC to adopt rules that would ensure smaller mobile communications networks have a chance to acquire that spectrum. AT&T argues that foreclosure is not a significant risk in wireless markets. It urges the FCC to hold an open auction and award all spectrum to the highest bidder.

The Use of Simulations to Assess the Effect of Vertical Mergers

Michael G. Baumann and Matthew B. Wright



Michael G. Baumann is a Senior Vice President at Economists Incorporated. He has extensive experience in analyzing mergers and using empirical methods in merger analysis. Matthew B. Wright is a Corporate Vice President and Principal at Economists Incorporated. He also has a wide range of experience evaluating both horizontal and vertical mergers and analyzing the competitive effects of vertical restraints. Both were part of the team that helped analyze and develop merger simulation models for the Toyota-Cascade transaction.

In recent years, U.S. competition authorities have extensively scrutinized non-horizontal mergers. Prominent examples include Comcast-NBC and Google-ITA. In both cases, concern about potential input foreclosure was both a significant focus of the merger investigation and a major element of the antitrust remedy. Experience in a recent investigation suggests that simulation models may play an increasingly important role in assessing the competitive effects of vertical mergers.

Competitive concerns regarding input foreclosure arise because a vertical merger can affect the incentives of the merging parties. For example, an upstream input supplier that formerly had an incentive to sell to all downstream buyers on comparable terms may face different incentives after the merger, because it now accounts for the impact of its actions on the profitability of its merger partner. If the downstream merger partner would benefit from the upstream merger partner's refusing to sell to rival downstream firms (a "total foreclosure" strategy), or supplying downstream rivals at prices above pre-merger levels (a "partial foreclosure" strategy), then the potential for input foreclosure may exist.

For input foreclosure to cause competitive harm, three conditions must hold. First, the merged firm must have the *ability* to foreclose its rivals. If the merged firm cannot effectively raise input prices to its rivals or deny its rivals access to the input, then foreclosure cannot occur. Second, the merged firm must have an incentive to foreclose. If attempted foreclosure would not be profitable, then foreclosure should not be a competitive concern. Third, foreclosure must harm *consumers*, not just competitors. If, despite any potential foreclosure, consumers benefit because of efficiencies specific to the merger, then the merger would not harm competition and should not be challenged.

Economists have found that vertical mergers raise competitive concerns only under limited circumstances. Indeed, because significant efficiencies may result, vertical mergers have considerable potential to produce competitive benefits. For example, consumers may benefit from the elimination of double marginalization. Double marginalization occurs when both the upstream and downstream firms have some market power and each prices at a markup over marginal cost. A vertical merger can eliminate one of the markups and increase output. Identifying the rare instances in which vertical mergers might raise competitive concerns is an important and difficult task for the competition agencies.

To aid their analysis, competition agencies have begun using quantitative approaches to analyze the incentive to foreclose and the likely competitive effects of foreclosure. For instance, enforcement agencies have used "vertical arithmetic" to consider the incentive for merging parties to engage in input foreclosure. Vertical arithmetic can be used to compare the likely costs to the potential benefits of foreclosure for the merging parties. The cost and benefits depend on many factors, including the relative margins of the merging firms, the magnitude of lost upstream sales resulting from the foreclosure, and the likely increase in the downstream merger partner's sales due to the foreclosure strategy. Vertical arithmetic is most useful when considering the potential effect of total foreclosure. It is much less helpful in assessing incentives for partial foreclosure because it does not address the incentives to change input prices.

The potential competitive effects of partial foreclosure might instead be evaluated through merger simulation. While merger simulation has frequently been used to analyze horizontal mergers, its use to analyze vertical mergers is less common and more complicated. As in horizontal contexts, vertical merger simulation faces substantial challenges, including the need to assume the form of competitive behavior, to estimate relevant demand elasticities (or

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DOJ and AT&T Dispute Rules for Spectrum Auctions

Henry B. McFarland

The Federal Communications Commission (FCC) is considering whether it should restrict upcoming spectrum auctions to increase competition. The FCC recently began a rule making to determine how to auction blocks of low-frequency mobile spectrum. The Antitrust Division of the U.S. Department of Justice (DOJ) is urging the FCC to adopt auction rules that would ensure smaller mobile communications networks have a chance to acquire that spectrum. DOJ believes those networks might use the spectrum to increase competition and thus benefit consumers. AT&T, however, argues that DOJ's proposal would violate the FCC's mandate to promote competition rather than pick winners and losers.

DOJ contends that the goals for the FCC's auctions should be to put spectrum to use quickly and to promote consumer welfare in wireless communications markets. These goals are best served by ensuring that spectrum is auctioned in a way that does not create or enhance market power. If there is no risk of anticompetitive behavior, a simple auction will realize these goals. DOJ, however, believes that risk is present in the upcoming auctions.

According to DOJ, the value of spectrum to a bidder may have two components: use value and foreclosure value. Use value is the value the spectrum has in a competitive market. Foreclosure value is the additional value a firm may realize by preventing other firms from acquiring the spectrum and thus forestalling a rival's entry or expansion or raising a rival's costs. If a firm can foreclose competition by acquiring a given block of spectrum, it will be willing to pay more for the spectrum and thus may be the higher bidder in the auction. DOJ argues, however, that the spectrum should not be sold to firms that will use it to foreclose rivals, because such sales will harm consumers.

DOJ believes that there is a significant risk that the two largest nationwide carriers, AT&T and Verizon, might buy large amounts of spectrum in the forthcoming auction to foreclose their competitors. In DOJ's view, the risk of foreclosure increases in highly concentrated markets, and local mobile wireless markets are highly concentrated throughout the United States.

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EI Vice President Henry B. McFarland has dealt extensively with antitrust and other issues involving communications. He also has analyzed foreclosure and other antitrust issues in a wide variety of industries.

Moreover, DOJ contends that the spectrum that is soon to be auctioned is particularly competitively significant. The upcoming auction involves the 600 MHz band. DOJ believes that low-frequency spectrum, which it defines as any spectrum below 1 GHz (1000 MHz), has propagation characteristics that allow better coverage in rural areas and inside buildings. As a result, a carrier using this spectrum can serve rural areas with a smaller investment in facilities and equipment. Thus, carriers will be more competitive if they have a certain amount of low-frequency spectrum. Currently, the two largest mobile wireless companies have 78% of the low-frequency spectrum. The two smaller nationwide mobile wireless companies, Sprint and T-Mobile, have little such spectrum.

Thus, DOJ fears that AT&T and Verizon might try to acquire large amounts of the low-frequency spectrum that is coming up for auction to prevent smaller carriers from acquiring that spectrum and thus becoming more competitive. DOJ has asked the FCC to establish rules for its auctions that ensure that the smaller carriers have an opportunity to acquire low-frequency spectrum. A coalition that includes Sprint, T-Mobile and other smaller wireless carriers has sent the FCC a letter that supports the DOJ position.

AT&T is urging the FCC to reject what it calls DOJ's "extraordinary suggestion" that the FCC should adopt rules to "help two specific providers, Sprint and T-Mobile." AT&T contends that firms cannot acquire spectrum just to exclude rivals. It cites the statement of a former FCC Chairman that past allegations of spectrum hoarding were "illusory." Moreover, it argues that the FCC will establish build-out requirements, requirements that the spectrum be put to use by a certain time, for any acquirer of the spectrum being auctioned. AT&T contends that such requirements prevent foreclosure.

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Simulation Models

diversion patterns), to account for relevant cost savings, and to assume a particular functional form of the demand curve. Vertical merger simulation not only faces those issues but also requires assumptions about the willingness of consumers to switch from one combination of upstream and downstream products to another, about the competitive interactions between the upstream and downstream firms, and about the manner in which vertical integration affects these interactions. Changes in the merged firm's pricing incentives, including the elimination of double marginalization, also present challenges to modeling vertical merger effects.

DOJ recently employed merger simulation in its analysis of a vertical transaction, the acquisition of Cascade Corporation, a lift-truck attachment manufacturer, by Toyota Industries Corporation, a lift truck manufacturer. Lift truck attachments include forks and specialized attachments, such as clamps and rotators, used for specific applications. DOJ's review focused in part on whether the transaction might lead Cascade to engage in partial input foreclosure when supplying specialized attachments for use with lift truck brands that compete against Toyota.

As part of its analysis, DOJ developed a merger simulation model to predict the likely competitive effects of the transaction. Given the absence of data about several important inputs for the simulation exercise, DOJ made several simplifying assumptions. These assumptions included that diversions in response to relative price changes would be in proportion to current shares, that pricing decisions about lift truck attachments and lift trucks were made sequentially rather than simultaneously, and that each lift truck brand could only be paired with one brand of lift truck attachment.

That DOJ made many (and in some cases, unrealistic) assumptions reflects the difficulty in calibrating the model and highlights the challenges with using simulations to estimate the effects of vertical mergers. In response to DOJ's modeling effort, the parties' economic consultants developed their own simulation model that relaxed some of the most restrictive DOJ assumptions. For instance, the parties' model allowed for simultaneous pricing decisions by attachment and lift truck manufacturers and permitted purchasers of any lift truck brand to pair the lift truck with any attachment brand. When merger-specific efficiencies (such as elimination of double marginalization) were accounted for, the parties' model suggested that under most scenarios average prices to consumers would fall after the transaction. After the model's findings were presented to DOJ, DOJ permitted the merger to proceed without any conditions.

The antitrust agencies are likely to increase their scrutiny of vertical mergers and employ increasingly sophisticated merger simulation models. While these models may help focus merger analysis, it is important to understand their limitations and to ensure that the assumptions that underlie any model are well suited to the merger being analyzed.

Rules for Spectrum Auctions

AT&T argues that both Sprint and T-Mobile do not need help acquiring additional spectrum. Both firms already have a substantial amount of spectrum. In fact, Sprint has more spectrum than either AT&T or Verizon. Moreover, both firms have substantial financial resources.

Moreover, AT&T contends that low-frequency spectrum is not essential for a firm to compete effectively in mobile communications. Neither Sprint nor T-Mobile chose to bid in the FCC's most recent auction of low-frequency spectrum. AT&T suggests their failure to bid is inconsistent with DOJ's view of the importance of that spectrum.

Furthermore, AT&T argues that if the low-frequency spectrum has better propagation characteristics that make it less costly to use than other spectrum, then it also will have a higher price in a competitive market. While it may be cheaper to use, it will be more costly to acquire. Thus, in a competitive market, a firm may not be able to lower its total costs by buying and using that spectrum. But if a firm cannot lower its costs by acquiring that spectrum, then another firm cannot raise its rival's costs by preventing that acquisition.

AT&T urges the FCC to hold an open auction and award all spectrum to the highest bidder. Such a policy would result in the greatest public revenues from the auction. Moreover, AT&T states that auction rules that favor certain bidders would be unlawful and inconsistent with the FCC's statutory mandate "to protect competition not competitors."

The 600 MHz auction likely will take place next year. The FCC has yet to decide whether it will adopt rules ensuring that smaller wireless companies have access to that spectrum, as advocated by DOJ, or whether it will simply award the spectrum to the highest bidder, as advocated by AT&T.

EI News and Notes

FTC Closes Investigation of Univar

The Federal Trade Commission (FTC) recently closed its investigation of Univar, Inc. The FTC investigated whether Univar or other manufacturers or distributors of bleach had violated Section 5 of the FTC Act by allocating customers or coordinating price or output. EI economists Barry C. Harris and Lona Fowdur worked with attorneys from White & Case to show that Univar had not engaged in anticompetitive conduct and no action by the FTC was necessary.

EI Economists Named to Positions in the Antitrust Section

Three EI economists have been named to leadership positions in the Antitrust Section of the American Bar Association. Philip B. Nelson was named Co-Chair of the Health Care and Pharmaceuticals Committee. Henry B. McFarland was reappointed Vice-Chair of the Insurance and Financial Services Committee. Su Sun was reappointed Senior Editor of *The Antitrust Law Journal*, a flagship publication of the Section. The Antitrust Section is an organization of over 13,000 antitrust professionals that was formed to promote analysis, debate, and education in the field of antitrust law and policy.

PID Approves Highmark-West Penn Affiliation

The Pennsylvania Insurance Department (PID) recently approved Highmark's affiliation agreement with West Penn Allegheny Health System. The agreement created a major integrated delivery network in the Pittsburgh area. The PID investigated possible competitive effects of the agreement, the impact on competitors and the extent efficiencies from the agreement would affect healthcare and insurance rates. EI economists Barry C. Harris, Stephanie M. Mirrow and Allison I. Holt, working with attorneys from Buchanan Ingersoll & Rooney, showed that the Highmark-West Penn agreement would facilitate significant cost savings and increase competition in hospital and insurance markets.

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INCORPORATED

OFFICES:

2121 K Street, NW
Suite 1100
Washington, DC 20037
phone: (202) 223-4700
fax: (202) 296-7138

100 Spear Street
Suite 1000
San Francisco, CA 94105
phone: (415) 975-5510
fax: (415) 281-9151

www.ei.com

President
Jonathan L. Walker

Editor
Henry B. McFarland

Layout
Gregory E. Wurz

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